SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1933

No. 187

ARTHUR M. BROWN, PETITIONER,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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[1*] DOCKET No. 35,305.

ARTHUR M. BROWN

vs.

COMMISSIONER OF INT. REV.

APPEARANCES.

For Taxpayer: KENNETH N. LOGAN, C. P. A.
ARTHUR B. DUNNE, Esq.
For Commissioner: EUGENE MEACHAM, Esq.

DOCKET ENTRIES.

1928.

Feb. 20.—Petition received and filed. Taxpayer notified. (Fee paid.)

Feb. 21—Copy of petition served on General Counsel.

Apr. 20—Answer filed by G. C.

Apr. 23—Copy of answer served on taxpayer—Circuit Cal.

1930.

Mar. 11—Hearing set May 14, 1930, San Francisco, Cal.

May 5—Application for subpoena filed by taxpayer.

May 6—Subpoena duces tecum to R. H. Lucas issued. 5-6-30 Subpoena served.

May 14—Hearing had before Mr. Marquette on motion to consolidate with Dkts. 39,157

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*Page-number appearing at the top of page of original certified Transcript of Record.

1930.

and 43,432 for hearing and decision. Granted. Continued to 5-15-30. Briefs due 9-15-30.

Aug. 16—Transcript of hearing of May 14 and 15, 1930, filed.

Sept. 12—Motion for extension to Sept. 30, 1930, to file brief filed by taxpayer. 9-15-30 Granted to 9-30-30.

Sept. 12—Motion for extension to Sept. 25, 1930, to file brief filed by G. C. 9-15-30 Granted to 9-30-30.

Sept. 16—Brief filed by taxpayer. (20 copies rec'd 9-17-30.)

Sept. 22—Brief filed by G. C.

1931.

Mar. 11—Findings of fact and opinion rendered, John J. Marquette, Div. 1. Judgment will be entered under Rule 50.

Mar. 16—Motion for judgment filed by G. C.

Mar. 20—Hearing set Apr. 15, 1931, under Rule 50.

Apr. 15—Hearing had before Mr. Marquette on settlement under Rule 50. Referred to Mr. Marquette for order.

Apr. 25—Decision entered, John J. Marquette, Div. 1.

Aug. 27—Stipulation to consolidate in one appeal with Dkts. 39,157 and 43,432 filed.

Sept. 4—Supersedeas bond in the amt. of $40,775.04 approved and ordered filed.

Sept. 8—Petition for review to U. S. Cir. Ct. of

1931.

Ap. (9) with assignments of error filed by taxpayer.

Sept. 9.—Proof of service filed.

Nov. 4—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare evidence and transmit record filed. (To Dec. 7. 1931.)

Dec. 3—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare evidence and transmit record filed. (To Jan. 6, 1932.)

Dec. 16—Statement of evidence lodged.

1932.

Jan. 5—Proof of service filed.

Jan. 6—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare evidence and transmit record filed. (To Feb. 5, 1932.)

[2] Docket No. 35,305.

Jan. 6—Praecipe filed.

Jan. 6—Request to present statement on Jan. 18, 1932, filed.

Jan. 6—Notice of lodgment of statement and of hearing Jan. 18, 1932, filed.

Jan. 6—Affidavit of service of statement and above papers filed.

Jan. 9—Notice of change of hearing to Jan. 20, 1932.

Jan. 21—Statement of evidence approved and ordered filed.

1932.

Jan. 20—Hearing had before Mr. Arundell, Div. 7, on approval of statement of evidence—Commissioner has no objection—referred to Mr. Marquette for approval.

Feb. 5—Order entered extending time for transmission and delivery of record to March 5, 1932.

Mar. 5—Order entered extending time for transmission and delivery of record to April 5, 1932.

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[3] DOCKET No. 39,157.

ARTHUR M. BROWN

vs.

COMMISSIONER OF INT. REV.

APPEARANCES.

For Taxpayer: KENNETH N. LOGAN, C. P. A.
A. B. DUNNE, Esq.

For Commissioner: EUGENE MEACHAM, Esq.

DOCKET ENTRIES.

1928.

June 6—Petition received and filed. Taxpayer notified. (Fee paid.)

June 7—Copy of petition served on General Counsel.

Aug. 6—Answer filed by G. C.

1928.

Aug. 8—Copy of answer served on taxpayer—Cir. calendar.

Dec. 21—Stipulation as to deficiency filed.

1930.

Mar. 11—Hearing set May 14, 1930, at San Francisco, Cal.

May 5—Application for subpoena filed by taxpayer.

May 6—Subpoena issued—Robert H. Lucas.

May 14—Hearing had before J. J. Marquette, Div. 1, called on petitioner's motion to consolidate with Docket Nos. 35,305 and 43,432 Granted. Briefs due 9-15-30.

Aug. 16—Transcript of hearing May 14, 1930, filed.

Sept. 12—Motion for extension to Sept. 30, 1930, to file brief filed by taxpayer, 9-15-30 Granted to 9-30-30.

Sept. 12—Motion for extension to Sept. 25, 1930, to file brief filed by G. C. 9-15-30 Granted to 9-30-30.

Sept. 16—Brief filed by taxpayer. See 35,305.

Sept. 22—Brief filed by G. C.

1931.

Mar. 11—Findings of fact and opinion rendered, John J. Marquette, Div. 1. Judgment will be entered under Rule 50.

Mar. 16—Motion for judgment filed by G. C. See 35,305.

Mar. 20—Hearing set April 15, 1931, on settlement.

Apr. 15—Hearing had before Mr. Marquette, Div.

1931

1, on settlement Rule 50. Referred to Mr. Marquette.

Apr. 25—Decision entered, Div. 1.

Aug. 27—Stipulation to consolidate in one appeal with Dkts. 35,305 and 43,432 filed.

Sept. 4—Supersedeas bond in the amount of $40,775.04 approved and ordered filed.

Sept. 8—Petition for review to U. S. Cir. Ct. of Ap. (9) with assignments of error filed by taxpayer.

Sept. 9—Proof of service filed.

Nov. 4—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare statement and transmit record filed.

Dec. 3—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare statement and transmit record filed.

Dec. 16—Statement of evidence lodged.

[4] Docket No. 39,157.

1932.

Jan. 5—Proof of service of statement filed.

Jan. 6—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare statement and transmit record filed.

Jan. 6—Praecipe filed.

Jan. 6—Request to present statement to member for approval on Jan. 18, 1932, filed.

1932.

Jan. 6—Notice of lodgment of statement and of hearing on Jan. 18, 1932, filed.

Jan. 6—Affidavit of service of statement and above papers filed.

Jan. 9—Notice changing hearing date to Jan. 20, 1932.

Jan. 21—Statement of evidence approved and ordered filed.

Jan. 20—Hearing had before Mr. Arundell, Div. 7, on approval of statement of evidence—Commissioner has no objection—referred to Mr. Marquette for approval.

Feb. 5—Order entered extending time for transmission and delivery of record to March 5, 1932.

Mar. 5—Order entered extending time for transmission and delivery of record to April 5, 1932.

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[5] DOCKET No. 43,432.

ARTHUR M. BROWN

vs.

COMMISSIONER OF INT. REV.

APPEARANCES.

For Taxpayer: KENNETH N. LOGAN, C. P. A.
ARTHUR B. DUNNE, Esq.

For Commissioner: EUGENE MEACHAM, Esq.

DOCKET ENTRIES.

1929.

Apr. 1—Petition received and filed. Taxpayer notified. (Fee paid.)

Apr. 2—Copy of petition served on General Counsel.

May 31—Answer filed by G. C.

June 3—Copy served on taxpayer—Cir. Cal.

1930.

Mar. 11—Hearing set May 14, 1930, at San Francisco, California.

May 5—Application for subpoena filed by taxpayer.

May 6—Subpoena issued—duces tecum—Robt. H. Lucas.

May 14—Hearing had before J. J. Marquette, Div. 1. Called on petitioner's motion to consolidate with 35,305 and 35,157 for hearing and decision. Granted. Briefs due 9–15–30.

Aug. 16—Transcript of hearing May 14 and 15 filed.

Sept. 12—Motion for extension to Sept. 30, 1930, to file briefs filed by taxpayer. 9–15–30 granted to 9–30–30.

Sept. 12—Motion for extension to Sept 25, 1930, to file brief filed by G. C. 9–15–30 Granted to 9–30–30.

Sept. 16—Brief filed by taxpayer.

Sept. 20—Brief filed by G. C.

1931.

Mar. 11—Findings of fact and opinion rendered, John J. Marquette, Div. 1. Judgment will be entered under Rule 50.

Mar. 16—Motion for judgment filed by G. C.

Mar. 20—Hearing set April 15, 1931, on settlement.

Apr. 15—Hearing had before Mr. Marquette, Div. 1 on settlement rule 50. Assigned to Mr. Marquette, Div. 1.

Apr. 25—Decision entered, Div. 1.

Aug. 27—Stipulation to consolidate on one appeal with Dkts. 35,305 and 39,157 filed.

Sept. 4—Supersedeas bond in the amount of $40,775.04, approved and ordered filed.

Sept. 8—Petition for review to U. S. Cir. Ct. of Appeals (9) with assignments or error, filed by taxpayer.

Sept. 9—Proof of service filed.

Nov. 4—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare statement and transmit record filed.

Dec. 3—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to prepare statement and transmit record filed.

Dec. 16—Statement of evidence lodged.

[6] Docket No. 43,432.

1932.

Jan. 5—Proof of service of statement filed.

Jan. 6—Copy of order from U. S. Cir. Ct. of Ap. (9) extending time for 30 days to pre-

1932.

pare statement and transmit record filed.

Jan. 6—Praecipe filed.

Jan. 6—Request to present statement of evidence on January 18, 1932, filed.

Jan. 6—Notice of lodgment of statement and of hearing on January 18, 1932, filed.

Jan. 6—Affidavit of service of statement and above papers filed.

Jan. 9—Notice changing hearing date from Jan. 18, 1932, to Jan. 20, 1932.

Jan. 21—Statement of evidence approved and ordered filed.

Jan. 20—Hearing had before Mr. Arundell on approval of statement of evidence; respondent has no objection; referred to Mr. Marquette for approval.

Feb. 5—Order entered extending time for transmission and delivery of record to March 5, 1932.

Mar. 5—Order entered extending time for transmission and delivery of record to April 5, 1932.

[7] Filed Feb. 20, 1928.

United States Board of Tax Appeals.

DOCKET No. 35,305.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION.

The above-named taxpayer and petitioner hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter IT:FAR:B-2 LCT-60D, dated December 22, 1927, and as a basis of his appeal sets forth the following:

1. The taxpayer is a resident of the State of California and was doing business under the fictitious name of Edward Brown & Sons, with his principal office at 200 Bush Street, San Francisco, California.

2. The deficiency letter (copy of which is attached) was mailed to the taxpayer on December 22, 1927, and states a deficiency of $17,923.03.

3. The tax in controversy is income tax for the calendar year 1923, and is more than $10,000.00, to wit—$17,923.03.

4. The determination of the tax contained in said deficiency letter is based upon the following errors:

a. The Commissioner disallows as a deduction from taxable income a charge, made by the taxpayer, of $52,971.96, representing a reduction of overriding commission income to take care of return commissions.

b. The Commissioner disallowed the deduction because he claimed that it set up a reserve for return commissions, and that while such a reserve is allowed by special statutory provision for insurance companies, the business of the taxpayer is not that of an insurance company and the taxpayer is therefore not entitled to the same provisions.

[8] c. He also disallows as a deduction from the net taxable income to be reported by the taxpayer from the General Insurance Agency business the payment made by the business of $3,000.00 to Edith H. Halton.

5. The facts upon which the taxpayer relies as the basis of his appeal are as follows:

a. The business of the taxpayer was that of a General Insurance Agency representing several Insurance Companies on the Pacific Coast and in the Orient. It was a joint venture between himself and Mrs. Edith H. Halton and commenced operations on August 1, 1922. Mrs. Halton's interest being limited to a fixed annual payment of $3,000.00; the business was in fact virtually that of an individual.

Under the terms of his several contracts with the Insurance Companies the Agency was to receive as part of its revenue certain percentages of the premiums on insurance policies written in its territory, to accrue to it in consideration for its representation

of the several insurance companies in the territory assigned to it.

The duties to be performed by him as general agent were practically all duties which would be performed by the insurance companies themselves if they were operating directly in the territory. They included, for example—

1—Obtaining business,

2—Writing of policies and applying correct Standard Forms,

3—Computing of premiums to be paid Insurance Companies,

4—Computing commissions to be paid to brokers,

5—Computing overriding commissions to be paid their Agency,

6—Collection of premiums and remittance to Home Office of Insurance Companies,

7—Placing of reinsurance,

8—Preparation and correction of Map Books for determination of risks to be placed,

9—Adjustment of losses,

10—Settlement thereof with insured,

11—Preparation of cancellation of policies, computing and repayment of return premiums,

12—Computing and adjustment of return commissions and overriding commissions,

13—Issuing of covering notes, "riders" to policies for change in original policies, etc.,

14—Preparation of daily, monthly and yearly Borderaux to Home Offices for new business, reinsurance, cancellations, losses, premium income and settlement sheets,

15—Purchasing of forms, policies, etc., for use of Insurance Companies,

16—Preparation of Municipal, State and Federal reports for Insurance Companies,

[9] and many other duties too numerous to relate in a concise statement of facts.

As stated above, a measure for the payment of these continuous services was a percentage of the premiums written in its territory. This accrual of income is termed "overriding commissions."

Under the terms of the contracts with the several insurance companies the overriding commissions were subject to all of the conditions to which the premiums of an insurance company were subjected. These conditions were:

(1) The premiums were not collected by the General Agent until sixty days after the policy was written. The commissions were, therefore, not credited to the General Agent until that time had elapsed.

(2) An insurance policy being an instrument based on time, the measure of premium income and overriding commission income were likewise based on time. That is, if a policy is written for one year's duration and bears a premium of, say, $100.00, the same face value of policy, if written for three years, would carry a premium of approximately two times the one year premium, or, say, $200.00, and a five-year policy three times, or, say, $300.00; and the overriding commission, if the commission were, say, ten per cent, which would be ultimately earned by the General Agency, if the policy

remained in force throughout its full term, would be in the first case $10.00, in the second $20.00 and the third $30.00.

(3) Subject to the sixty days grace period, premiums on policies were paid in advance. These payments were subject to refund upon cancellation of the policy, as shown in item 4 below, and constituted a direct liability of the insurance company in the proportion that the unexpired term of the policy bore to the total life of the policy. The law, recognizing this liability, required the insurance companies to set up the liability on their balance sheets and to withhold from premium income all unearned premiums, and prescribed the method to be followed in determining the amount. The same liability existed in the case of General Agents upon the receipt by them of overriding commissions, and the taxpayer, recognizing this liability, set up on his books a liability for the year 1923 of $52,971.96. In setting up this amount as a liability the taxpayer used as a basis, not the unexpired portion of the overriding commission deposit outlined for insurance companies in their treatment of insurance premiums, but only a liability for unexpired overriding commission deposits, which his previous experience as a general agent told him would surely have to be repaid to the insurance companies through actual cancellation of policies and the refund of overriding commissions as discussed in the next paragraph.

(4) Insurance policies, on which overriding commissions were paid, were subject to cancellation

at any time during the life of the policy, either at the request of the assured or the insuring company. Upon the cancellation of a policy the General Agent computed the amount of premium which had not expired (amount which had not been earned by the insuring company through failure of the policy [10] to run its full life) and made refund to the assured accordingly. He likewise computed the unexpired (unearned) overriding commission and refunded same to the insurance company.

It has been argued by the Commissioner, although not set forth in his deficiency letter of December 22, 1927,that the establishment of a liability for return overriding commissions due to cancellations, based upon previous experience of the ratio of cancellations to total premiums written, cannot be allowed, as that method does not provide an accurate means of determining the exact amount of the liability. If there is any merit in his contention, the taxpayer claims the right to set up as a liability as at the close of the year 1923 the full unexpired deposit on overriding commissions, because until the actual lapse of time has taken place the total unearned overriding commission is subject to refund, and therefore constitutes a tangible liability of the General Agency.

b. The taxpayer claims that the right to set up a liability to take care of obligations incurred by him as a General Agent and to withhold from taxable income in any year that income which had not accrued to him unconditionally was not dependent upon the establishment of the fact that the General

Agent was conducting an insurance business, and so came under the special statutory provisions governing insurance companies and their establishment of a so-called reserve, which we believe is a misnomer. He claims that the Revenue Act required all business enterprises keeping their books on the accrual basis to report in the taxable year in question only such income as had actually been earned by them in that year and to carry over to subsequent years all items of income and expense which should be properly accounted for as of a different period. He further claims that, in order to truly reflect his financial status, he must establish on his books liabilities which existed and for which he was legally liable.

The books of the taxpayer were kept on the accrual basis, which fact has been acknowledged by the Commissioner.

c. The $3,000.00 paid to Mrs. Edith H. Halton, sister of the taxpayer, which was disallowed as a deduction by the Commissioner, has already been the subject of an appeal to your honorable Board for the years 1920 and 1921, heard on July 6–7, 1927 (the year 1922 reflected a refund and therefore did not come under the jurisdiction of the Board of Tax Appeals), for which years a decision was rendered in favor of the taxpayer following and agreement by stipulation with the Solicitor to the Treasury Department. This deduction has been continuous yearly from 1904, following the death of taxpayer's father, from whom the taxpayer and his brother inherited the business of Edward Brown

& Sons. The yearly payment to the sisters of taxpayer constituted the sisters' participation in the business of Edward Brown & Sons. Such deduction was originally based upon a percentage of the earnings of the business, but at the request of the sisters, who wished to be assured of the amount to be received by them, it was changed to a fixed sum of $3,000.00 per annum, being their proportion of the then estimated average earnings.

[11] The interest of Mrs. Halton in the business left by Mr. Edward Brown was carried into the joint venture established by Mr. Arthur M. Brown and Mrs. Edith H. Halton, upon the dissolution of the partnership on July 31, 1922, by the payment to her of the same stipulated amount, i. e., $3,000.00 per annum, as she was receiving in prior years.

6. The taxpayer in support of his appeal relied upon the following propositions of law:

a. (1) Section 212–b of the Revenue Act of 1921, which defines net income of a taxpayer and states in part that the net income to be reported must clearly reflect the income.

(2) Article 23 of the Regulations 62 pertaining to Section 212, which defines the basis of computation. This article holds that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. A taxpayer is deemed to have received

items of gross income which have been credited to or set apart for him without restriction." (Underlining not part of quotation.)

b. Article 1507 of the regulations covering Section 2 defines joint adventure. Office Decision 425, 2 C. B. 198, states: "The management of property held by a number of brothers and sisters as tenants in common under the father's will, and the distribution of income therefrom, by one of the brothers under an oral agreement, does not constitute a legal trust. Each beneficiary should file a separate return, including therein his share of the income from the property and claiming a proportionate share of any allowable deductions."

WHEREFORE, the taxpayer respectfully prays that this Board may hear and determine its appeal.

KENNETH N. LOGAN,
Certified Public Accountant,
Accountant for Taxpayer.

KENNETH N. LOGAN,
1222 Balfour Building,
San Francisco, California.

[12] Arthur M. Brown, being duly sworn, says that he is the taxpayer in the foregoing petition; that he has read the said petition and is familiar with the statements therein contained, and that the facts therein stated are true, except such facts as are stated to be upon information and belief, and those facts he believes to be true.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 14th day of February, 1928.

[Seal] LULU P. LOVELAND,
Notary Public in and for the City and County of San Francisco, State of California.

[13] COPY.

December 22, 1927.

IT:FAR:B-2.
LCT-60D.

Mr. Arthur M. Brown,
200 Bush Street,
San Francisco, California.

Sir:

The determination of your income tax liability for the year 1923, discloses a deficiency of $17,923.03, as shown by the attached statement.

In accordance with the provisions of Section 274 of the Revenue Act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the Board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final decision on

such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the Collector of Internal Revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the inclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:FAR:B-2-LCT-60D. In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully,
D. H. BLAIR,
Commissioner.

Inclosures:
Statement.
Form A.
Form 882 SDG-2.

[14] COPY.

STATEMENT.

IT:FAR:B-2.
LCT-60D.

Dec. 22, 1927.

In re: Mr. Arthur M. Brown,
200 Bush Street,
San Francisco, California.

Year.	Deficiency in Tax.
1923.	$17,923.03.

The report of the Internal Revenue Agent in

Charge at San Francisco, California, transmitted to this office under date of July 23, 1927, has been reviewed with the following exception:

The deduction of $3,185.15 for Christmas Gifts to Employees has been allowed. This deduction was an ordinary and necessary business expense of the concern when it was made and it was recommended by the Internal Revenue Agent in Charge that the amount be allowed.

The revenue agent has been sustained in regard to the disallowance of the deduction of $52,971.96, representing a reserve for return commissions. Insurance companies are entitled under the Law to set up such reserves, and you contend that being in the insurance business you would be entitled to the same method of computing income. In this connection, you are advised that the provisions of the Law governing insurance companies for the purpose of setting up reserves is statutory. Your business is not an insurance company inasmuch as you are acting as an agent in writing insurance policies for which you receive a commission. It, therefore, cannot be held that you are entitled to the same provisions as an insurance company.

It has been held by this office that the deduction of $3,000.00 paid to Edith H. Holton, is a capital expenditure and is not deductible from income. It has also been held by this office that the deduction for a payment to the Industrial Association of San Francisco is not allowable.

It is noted that all other adjustments as made by the Revenue Agent have been conceded by you.

Mr. Arthur M. Brown. Statement.

Net Income originally reported.....			$35,563.20
Salaries reported.....		$18,000.00	
As adjusted.....		21,600.00	
			3,600.00
Income from business reported.....	$15,590.75		
As adjusted.....	73,668.11		
			58,077.36
Other deductions as claimed.....	2,413.36		50.00

As adjusted	2,363.36		
Total income as adjusted		97,290.56	
Dividends and exemption		6,479.20	
Amount subject to normal tax		90,811.36	
Total tax			28,298.57
25% Reduction, Revenue Act of 1924			7,074.64
Net tax assessable			21,223.93
Tax assessed	4,401.20		
25% Reduction, Revenue Act of 1924	1,100.30		3,300.90
Deficiency			17,923.03

Payment of the tax should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

SDG–2.

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[16] Filed Apr. 20, 1928. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 35,305.

BROWN, ARTHUR M.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ANSWER.

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits the allegations contained in Paragraph 2 of the petition.

3. Admits the allegations contained in Paragraph 3 of the petition.

4. Denies that the Commissioner erred as alleged

in subdivisions 4(a), 4(b) and 4(c) of Paragraph 4 of the petition.

5. Denies generally and specifically each and every allegation set forth in taxpayer's petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the taxpayer's appeal be denied.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
PHILIP M. CLARK,
Special Attorney,
Bureau of Internal Revenue.

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[17] Filed June 6, 1928.

May 22, 1928.

United States Board of Tax Appeals.

DOCKET No. 39,157.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION.

The above-named taxpayer and petitioner hereby appeals from the determination of Commissioner of Internal Revenue set forth in his deficiency letter dated April 28, 1928, Reference IT:FAR:B-12

RRP–60 D, and as basis of his appeal sets forth the following:

1. The taxpayer is a resident of the State of California and was doing business as a partner in Edward Brown & Sons, with its principal office at 200 Bush Street, San Francisco, California.

2. The deficiency letter, copy of which is attached, was mailed to the taxpayer on April 28, 1928, and states a deficiency of $1,520.19.

3. The tax in controversy is income tax for the calendar year 1925 and is less than $10,000.00, to wit, $1,520.19.

4. The taxpayer admits all the changes made by the Commissioner to his original return, except in the matter of increase of partnership (Edward Brown & Sons) income for 1925, in the amount of $3,292.98, being part of the Commissioner's addition to partnership income of $7,491.80.

5. The determination of the tax contained in said deficiency letter is based upon the following errors:

[18] (a) The Commissioner disallows as a deduction from taxable income a charge made on the books of the partnership of Edward Brown & Sons, representing a reduction of overriding commission income to take care of commissions which would have to be returned. In 1925 the net amount so disallowed amounted to $3,292.98.

(b) The Commissioner disallowed this deduction in line with his ruling for 1923, which has become a matter of appeal to your honorable board under docket number 35,305, and while not now

so distinctly stating, bases his decision that such charge is a reserve set up for return commission, and that while such a reserve is allowed by special statutory provision for Insurance Companies, the business of the taxpayer is not that of an Insurance Company, and the taxpayer is, therefore, not entitled to the same provisions.

6. The facts upon which the taxpayer relies as the basis of his appeal are as follows:

(a) The taxpayer is a partner in Edward Brown & Sons, holding a 19/24 interest therein.

(b) The business of Edward Brown & Sons is that of a General Insurance Agency representing several Insurance Companies on the Pacific Coast and in the Orient.

Under the terms of the several contracts with the Insurance Companies the Agency was to receive as part of its revenue certain percentages of the premiums on insurance policies written in its territory, to accrue to it in consideration for its representation of the several insurance companies in the territory assigned to it.

The duties to be performed by the partnership as General Agents were practically all duties which would be performed by the insurance companies themselves if they were operating directly in the territory. They included, for example—

1—Obtaining business,

2—Writing of policies and applying correct Standard Forms,

3—Computing of premiums to be paid Insurance Companies,

4—Computing commissions to be paid to brokers,
5—Computing overriding commissions to be paid their Agency,
6—Collection of premiums and remittance to Home Office of Insurance Companies,
7—Placing of reinsurance,
8—Preparation and correction of Map Books for determination of risks to be placed,
9—Adjustment of losses,
10—Settlement thereof with insured,
11—Preparation of cancellation of policies, computing and repayment of return premiums,
12—Computing and adjustment of return commissions and overriding commissions,
13—Issuing of covering notes, "riders" to policies for change in original policies, etc.,
[19] 14—Preparation of daily, monthly and yearly Borderaux to Home Offices for new business, reinsurance, cancellations, losses, premium income and settlement sheets,
15—Purchasing of forms, policies, etc., for use of Insurance Companies,
16—Preparation of Municipal, State and Federal reports for Insurance Companies,

and many other duties too numerous to relate in a concise statement of facts.

As stated above, a measure for the payment of these continuous services was a percentage of the premiums written in its territory. This accrual of income is termed "overriding commissions."

Under the terms of the contracts with the several insurance companies the overriding commis-

sions were subject to all of the conditions to which the premiums of an insurance company were subjected. These conditions were:

(1) The premiums were not collected by the General Agents until sixty days after the policy was written. The commissions were, therefore, not credited to the General Agents until that time had elapsed.

(2) An insurance policy being an instrument based on time, the measure of premium income and overriding commission income were likewise based on time. That is, if a policy is written for one year's duration and bears a premium of, say, $100.00, the same face value of policy, if written for three years, would carry a premium of approximately two times the one year premium, or, say, $200.00, and a five-year policy three times, or, say, $300.00; and the overriding commission, if the commission were, say, ten per cent, which would be ultimately earned by the General Agency, presuming the policy remained in force throughout its full term, would be in the first case $10.00, in the second $20.00 and the third $30.00.

(3) Subject to the sixty days' grace period, premiums on policies were paid in advance. These payments were subject to refund upon cancellation of the policy, as shown in Item 4 below, and constituted a direct liability of the insurance company in the proportion that the unexpired term of the policy bore to the total life of the policy. The law, recognizing this liability, required the insurance companies to set up the liability on their balance

sheets and to withhold from premium income all unearned premiums, and prescribed the method to be followed in determining the amount. The same liability existed in the case of General Agents upon the receipt by them of overriding commissions, and the Partnership, recognizing this liability, set up on their books a liability for the year 1925 of an amount to take care of estimated cancellations upon commissions earned on policies written. In setting up this amount as a liability they used as a basis, not the unexpired portion of the overriding commission deposit for insurance companies in their treatment of insurance premiums, but only a liability [20] for unexpired overriding commission deposits, which previous experience as general agents indicated would surely have to be repaid to the insurance companies through actual cancellation of policies and the refund of overriding commissions as discussed in the next paragraph.

(4) Insurance policies, on which overriding commissions were paid, were subject to cancellation at any time during the life of the policy, either at the request of the assured or the insuring company. Upon the cancellation of a policy the General Agent computed the amount of the premium which had not expired (amount which had not been earned by the insuring company through failure of the policy to run its full life) and made refund to the assured accordingly. They likewise computed the unexpired (unearned) overriding commission and refunded same to the insurance company.

It has been argued by the Commissioner, although

not set forth in his deficiency letter of April 28, 1928, that the establishment of a liability for return overriding commissions due to cancellations, based upon previous experience of the ratio of cancellations to total premiums written, cannot be allowed, as that method does not provide an accurate means of determining the exact amount of the liability. If there be any merit in his contention, the taxpayer claims the right to set up as a liability the full unexpired deposit on overriding commissions, because until the actual lapse of time has taken place the total unearned overriding commission is subject to refund, and therefore constitutes a tangible liability of the General Agency. In other words, if denied the right to compute the amount of probable cancellations based upon past experience, the taxpayer claims the right to determine his actual earned income from commissions set up in the manner provided by law for insurance companies upon the amount of earned premiums calculated upon premiums received.

(c) The taxpayer claims that the right to set up a liability to take care of obligations incurred by the partnership as General Agents and to withhold from taxable income in any year that income which had not accrued to it unconditionally was not dependent upon the establishment of the fact that the General Agents were conducting an insurance business, and so came under the special statutory provisions governing insurance companies and their establishment of a so-called reserve, which we believe is a misnomer, but he does claim that

the Revenue Act required all business enterprises keeping their books on the accrual basis to report in the taxable year in question only such income as had actually been earned by them in that year and to carry over to subsequent years all items of income and expense which should be properly accounted for as of a different period. He further claims, that in order to truly reflect the partnership's financial status, it must establish on its books liabilities which existed and for which it was legally liable, or in lieu thereof only report such income as has accrued to it unconditionally and without restriction.

The books of the partnership were kept on the accrual basis, which fact has been acknowledged by the Commissioner.

[21] 7. The taxpayer in support of his appeal relies upon the following propositions of law:

a. (1) Section 212–b of the Revenue Act of 1921, which defines net income of a taxpayer and states in part that the net income to be reported must clearly reflect the income.

(2) Article 23 of the Regulations 62 pertaining to section 212, which defines the basis of computation. This article holds that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. A taxpayer is deemed to have received items of gross

income which have been credited to or set apart for him without restriction." (Underlining not part of quotation.)

WHEREFORE, the taxpayer respectfully prays that this Board may hear and determine his appeal.

KENNETH N. LOGAN,
Certified Public Accountant,
Accountant for Taxpayer.

KENNETH N. LOGAN,
1222 Balfour Building,
San Francisco, California.

[22] Arthur M. Brown, being duly sworn, says that he is the taxpayer in the foregoing petition; that he has read the said petition and is familiar with the statements therein contained, and that the facts therein stated are true, except such facts as are stated to be upon information and belief, and those facts he believes to be true.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 31 day of May, 1928.

[Seal] LULU P. LOVELAND,
Notary Public in and for the City and County of San Francisco, State of California.

[23] STATEMENT.

Apr. 28, 1928.

IT:FAR:B-12.
RRP:60D.

In re: Mr. Arthur Brown,
200 Bush Street,
San Francisco, California.

Year.	Deficiency.
1925.	$1,520.19.

Reference is made to the report of the Internal Revenue Agent in Charge at San Francisco, California, covering an investigation of your income tax liability for the year 1925, and to your letter dated April 16, 1928.

Relative to your request that the adjustment of additional income from the partnership of Edward Brown & Sons be held in abeyance pending the decision by the Board of Tax Appeals of your appeal for the year 1923, you are advised that it is not the policy of this office to grant such requests.

Your proportionate share of the donations disallowed to the partnership has been allowed as a deduction in determining your taxable income.

Net income reported on the return.....			$42,689.60
Add:			
1.	Partnership income	$7,491.80	
2.	Partnership dividends..	227.75	
3.	Stock assessment	812.50	8,532.05
			$51,221.65

Deduct:		
4. Stock loss	$ 50.00	
5. Liberty Bond Interest	10.63	
6. Contributions	423.54	484.17
Adjusted net income		$50,737.48

Computation of Tax.

Adjusted net income		$50,737.48
Less:		
Dividends	$3,407.25	
Exemption	3,500.00	6,907.25
Income subject to normal tax		$43,830.23

Copy.

[24] Mr. Arthur M. Brown. Statement.

Tax at 1½% on $ 4,000.00	$ 60.00
Tax at 3% on $ 4,000.00	120.00
Tax at 5% on $35,830.23	1,791.51
Surtax	3,075.87
Total	$5,047.38
Less:	
Earned income credit	$30.18
Tax paid at source	26.90 57.08
Net tax assessable	$4,990.30
Previously assessed	3,470.11
Deficiency	$1,520.19

Explanation of Changes.

1 and 2. The income to be reported from the

partnership has been adjusted in accordance with the changes made in the partnership income.

3. The assessments paid on Robbers Roost stock represent capital expenditures and should be added to the cost of the stock.

4. A loss of $50.00 from the sale of Chicago Northern stock was not claimed as a deduction on your return.

5. Nontaxable Liberty Bond interest was included as income.

6. Contributions have been increased by your proportionate share of those made through the partnership.

Payment of the deficiency in tax should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

Copy.

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[25] Filed Aug. 6, 1928. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 39,157.

BROWN, ARTHUR M.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ANSWER.

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits the allegations contained in Paragraph 2 of the petition.

3. Admits the allegations contained in Paragraph 3 of the petition.

4. Denies that the Commissioner committed err*ed* in the matter of increase of partnership (Edward Brown & Sons) income for 1925, in the amount of $3,292.98.

5. Denies that the Commissioner erred as alleged in subdivisions 5(a) and 5(b) of Paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation set forth in taxpayer's petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST.
C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
PHILIP M. CLARK,
Special Attorney,
Bureau of Internal Revenue.

[26] Filed April 1, 1929.

March 21, 1929.

United States Board of Tax Appeals.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION.

The above-named taxpayer and petitioner hereby appeals from the determination of Commissioner of Internal Revenue set forth in his deficiency letter dated February 7, 1929, Reference IT:AR:B–1 FMA–6OD, and as a basis of his appeal sets forth the following:

1. The taxpayer is a resident of the State of California and was doing business as a partner in Edward Brown & Sons, with its principal office at 200 Bush Street, San Francisco, California.

2. The deficiency letter, copy of which is attached, was mailed to the taxpayer on February 7, 1929, and states a deficiency of $944.30.

3. The tax in controversy is income tax for the calendar year 1926 and is less than $10,000.00, to wit, $944.30.

4. The taxpayer admits all the changes made by the Commissioner to his original return, except in the matter of increase of partnership (Edward

Brown & Sons) income for 1926, in the amount of $1,947.77, being part of the Commissioner's addition to the partnership income of $4,330.05.

5. The determination of the tax contained in said deficiency letter is based upon the following errors:

[27] (a) The Commissioner disallows as a deduction from taxable income a charge made on the books of the partnership of Edward Brown & Sons, representing a reduction of overriding commission income to take care of commissions which would have to be returned. In 1926 the net amount so disallowed amounted to $1,947.77.

(b) The Commissioner disallowed this deduction in line with his ruling for 1923, which has become a matter of appeal to your honorable board under Docket No. 35,305, and while not now so distinctly stating, bases his decision that such charge is a reserve set up for return commission, and that while such a reserve is allowed by special statutory provision for Insurance Companies, the business of the taxpayer is not that of an Insurance Company, and the taxpayer is, therefore, not entitled to the same provisions.

6. The facts upon which the taxpayer relies as the basis of his appeal are as follows:

(a) The taxpayer is a partner in Edward Brown & Sons, holding a 75% interest therein.

(b) The business of Edward Brown & Sons is that of a General Insurance Agency representing several Insurance Companies on the Pacific Coast and in the Orient.

Under the terms of the several contracts with the Insurance Companies the Agency was to receive as part of its revenue certain percentages of the premiums on insurance policies written in its territory, to accrue to it in consideration for its representation of the several insurance companies in the territory assigned to it.

The duties to be performed by the partnership as General Agents were practically all duties which would be performed by the insurance companies themselves if they were operating directly in the territory. They included, for example—

1—Obtaining business,

2—Writing of policies and applying correct Standard Forms,

3—Computing of premiums to be paid Insurance Companies,

4—Computing commissions to be paid to brokers,

5—Computing overriding commissions to be paid their Agency,

6—Collection of premiums and remittance to Home Office of Insurance Companies,

7—Placing of reinsurance,

8—Preparation and correction of Map Books for determination of risks to be placed,

9—Adjustment of losses,

10—Settlement thereof with insured,

11—Preparation of cancellation of policies, computing and repayment of return premiums,

12—Computing and adjustment of return commissions and overriding commissions,

[28] 13—Issuing of covering notes, "riders" to policies for change in original policies, etc.
14—Preparation of daily, monthly and yearly Borderaux to Home Offices for new business, reinsurance, cancellations, losses, premium income and settlement sheets,
15—Purchasing of forms, policies, etc., for use of Insurance Companies,
16—Preparation of Municipal, State and Federal reports for Insurance Companies,
and many other duties too numerous to relate in a concise statement of facts.

As stated above, a measure for the payment of these continuous services was a percentage of the premiums written in its territory. This accrual of income is termed "overriding commissions."

Under the terms of the contracts with the several insurance companies the overriding commissions were subject to all of the conditions to which the premiums of an insurance company were subjected. These conditions were:

(1) The premiums were not collected by the General Agents until sixty days after the policy was written. The commissions were, therefore, not credited to the General Agents until that time had elapsed.

(2) An insurance policy being an instrument based on time, the measure of premium income and overriding commission income were likewise based on time. That is, if a policy is written for one year's duration and bears a premium of, say $100.00, the same face value of policy, if written for three years, would carry a premium of approximately

two times the one year premium, or, say, $200.00, and a five year policy three times, or, say, $300.00; and the overriding commission, if the commission were, say, ten per cent, which would be ultimately earned by the General Agency, presuming the policy remained in force throughout its full term, would be in the first case $10.00, in the second $20.00 and the third $30.00.

(3) Subject to the sixty days' grace period, premiums on policies were paid in advance. These payments were subject to refund upon cancellation of the policy, as shown in Item 4 below, and constituted a direct liability of the insurance company in the proportion that the unexpired term of the policy bore to the total life of the policy. The law, recognizing this liability, required the insurance companies to set up the liability on their balance sheets and to withhold from premium income all unearned premiums, and prescribed the method to be followed in determining the amount. The same liability existed in the case of General Agents upon the receipt by them of overriding commissions, and the Partnership, recognizing this liability, set up on their books a liability for the year 1926 of an amount to take care of estimated cancellations upon commissions earned on policies written. In setting up this amount as a liability they used as a basis, not the unexpired portion of the overriding commission deposit outlined [29] for insurance companies in their treatment of insurance premiums, but only a liability for unexpired overriding commission deposits, which previous experience as

general agents indicated would surely have to be repaid to the insurance companies through actual cancellation of policies and refund of overriding commissions as discussed in the next paragraph.

(4) Insurance policies, on which overriding commissions were paid, were subject to cancellation at any time during the life of the policy, either at the request of the assured or the insuring company. Upon the cancellation of a policy th General Agent computed the amount of the premium which had not expired (amount which had not been earned by the insuring company through failure of the policy to run its full life) and made refund to the assured accordingly. They likewise computed the unexpired (unearned) overriding commission and refunded same to the insurance company.

It has been argued by the Commissioner, although not set forth in his deficiency letter of February 7, 1929, that the establishment of a liability for return overriding commissions due to cancellations, based upon previous experience of the ratio of cancellations to total premiums written, cannot be allowed, as that method does not provide an accurate means of determining the exact amount of the liability. If there be any merit in his contention, the taxpayer claims the right to set up as a liability the full unexpired deposit on overriding commissions, because until the actual lapse of time has taken place the total unearned overriding commission is subject to refund, and therefore constitutes a tangible liability of the General Agency. In other words, if denied the right to compute the

amount of probable cancellations based upon past experience, the taxpayer claims the right to determine his actual earned income from commissions set up in the manner provided by law for insurance companies upon the amount of earned premiums calculated upon premiums received.

(c) The taxpayer claims that the right to set up a liability to take care of obligations incurred by the partnership as General Agents and to withhold from taxable income in any year that income which had not accrued to it unconditionally was not dependent upon the establishment of the fact that the General Agents were conducting an insurance business, and so came under the special statutory provisions governing insurance companies and their establishment of a so called reserve, which we believe is a misnomer, but he does claim that the Revenue Act required all business enterprises keeping their books on the accrual basis to report in the taxable year in question only such income as had actually been earned by them in that year and to carry over to subsequent years all items of income and expense which should be properly accounted for as of a different period. He further claims, that in order to truly reflect the partnership's financial status, it must establish on its books liabilities which existed and for which it was legally liable, or in lieu thereof only report such income as has accrued to it unconditionally and without restriction.

The books of the partnership were kept on the accrual basis, which fact has been acknowledged by the Commissioner.

[30] 7. The taxpayer in support of his appeal relies upon the following proposition of law:

a. (1) Section 212–b of the Revenue Act of 1921, which defines net income of a taxpayer and states in part that the net income to be reported must clearly reflect the income.

(2) Article 23 of the Regulations 62 pertaining to section 212, which defines the basis of computation. This article holds that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction." (Underlining not part of quotation.)

WHEREFORE, the taxpayer respectfully prays that this Board may hear and determine his appeal.

KENNETH N. LOGAN,
Certified Public Accountant,
Accountant for Taxpayer.

KENNETH N. LOGAN,
1222 Balfour Building,
San Francisco, California.

[31] Arthur M. Brown, being duly sworn, says that he is the taxpayer in the foregoing petition; that he has read the said petition and is familiar with the statements therein contained, and that the facts therein stated are true, except such facts as

are stated to be upon information and belief, and those facts he believes to be true.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 25th day of March, 1929.

[Notarial Seal] KATHRYN E. STONE,
Notary Public in and for the City and County of San Francisco, State of California.

[32] STATEMENT.

Feb. 7, 1929.

IT:AR:B–1.
FMA–60D.

In re: Mr. Arthur M. Brown, Sr.,
200 Bush Street,
San Francisca, California.

Tax Liability.

Year.	Corrected Tax Liability.	Tax Previously Assessed.	Deficiency.
1926	$3,545.22	$2,600.92	$944.30

Reference is made to your letter dated December 17, 1928, in regard to the proposed deficiency in tax for the year 1926, as outlined in office letter addressed to you under date of December 3, 1928.

It appears that you have agreed with all the proposed changes in your net income for the year 1926 with the exception of your distributive share of the net income of the partnership of Edward Brown & Sons, in so far as such income is increased by the adjustment of $1,947.77 in the partnership's account, "Return Commissions." Inasmuch as a similar adjustment in the partnership income as re-

ported in your income tax return for the year 1923, is now pending before the United States Board of Tax Appeals, you request that further action with respect to this item for the year 1926 be deferred pending a decision of the United States Board of Tax Appeals in your 1923 case.

In this connection you are again advised that it is not the policy of this Bureau to withhold action on a taxpayer's return for a particular year pending the action of the United States Board of Tax Appeals on a petition filed with that body by the taxpayer for a redetermination of a deficiency proposed by the Income Tax Unit for another year or years.

Net income disclosed by return		$36,889.68
Add:		
1. Interest income	$ 1,514.00	
2. Partnership income	31,330.05	
3. Dividends increased	394.06	
4. Contributions decreased	18.75	
5. Assessments on stock disallowed	1,155.00	
6. Ranch expenses	242.39	
		34,654.25
		$71,543.93

Copy.

[33] Mr. Arthur M. Brown Senior.

Statement.

Brought forward	$71,543.93

Deduct:		
7. Salary from partnership	$27,000.00	
8. Interest income	1,296.81	
9. Profit from sale of stock rights	882.25	
10. Bad Debt Recoveries	242.39	29,421.45
Adjusted net income		$42,122.48
Less:		
Dividends	$ 3,019.79	
Personal exemption	3,500.00	6,519.79
Income subject to normal tax		$35,602.69

Computation of Tax.

Normal tax at 1½% on $4,000.00	60.00
Normal tax at 3% on 4,000.00	120.00
Normal tax at 5% on 27,602.69	1,380.13
Surtax on $42,122.48	2,033.47
Total tax	$ 3,593.60
Less:	
Earned income credit $ 18.10	
Tax paid at source 30.28	
	48.38
Tax liability stated on Form 866	$3,545.22
Less:	
Tax previously assessed	2,600.92
Proposed deficiency	$ 944.30

Explanation of Changes.

1. Interest received on tax-free covenant bonds has been found to be $1,514.00, whereas no amount was reported under Item 3 (a) of your return. However, it is disclosed that $1,296.81 of such interest was erroneously reported under Item 3 of your return. For further explanations see Change #8 below.

Copy.

[34] Mr. Arthur M. Brown, Senior.

Statement.

2. The adjustments in the net income of Edward Brown & Sons as set forth and explained in the revenue agent's report on this partnership, a copy of which was furnished the firm, have been reviewed and approved, with the exception that the payment of $2,200.00 to Mrs. E. Halton has been allowed as claimed on the partnership's return, Form 1065, filed for the year 1926. Therefore, your distributive share of the net income of this partnership has been decreased from $41,216.21, the amount disclosed by the Internal Revenue Agent, to $39,566.21. This reduction of $1,650.00 in partnership income represents your three-fourths share of the payment of $2,200.00 made by the partnership to Mrs. E. Halton.

3. Dividends received are $3,019.79, instead of $2,625.73, the amount reported on your return. The difference of $394.06 has been added to the income in accordance with Section 213 (a) of the Revenue Act of 1926.

4. Your three-fourths share of contributions of

$717.00 made through the partnership of Edward Brown & Sons is $537.75, instead of $556.50, the amount shown on your return. The difference of $18.75 has been added to the income.

5. Assessments on the capital stock of a corporation paid by its stockholders are held to constitute an addition to the cost of the stock and as such are not allowable as deductions from the gross income. This adjustment is in accordance with Article 292 of Regulations 69.

6. This adjustment is offset by the ranch income in the amount of $242.39 reported under Item 9 (a) of the return and which has been eliminated from income.

7. This item, representing salary from the partnership of Edward Brown and Sons, has been transferred to Line 4 of the return.

8. Interest of $1,296.81 received on tax-free covenant bonds has been included in adjustment #1 above.

9. This item represents the adjustment of the cost of stock rights, which you failed to claim as a deduction from the selling price of these assets.

10. See Explanation of Change #6 above.

Copy.

[35] Mr. Arthur M. Brown, Senior.

Statement.

The reduction in the earned income credit from $206.25, the amount reported on your return, to $18.10, is due to the fact that your earned net income is limited to 20% of the partnership income of $39,566.21, or $7,913.24. This adjustment is in

accordance with Section 209 (a) (1) of the Revenue Act of 1926, as interpreted by Mimeograph #3471, reported in Internal Revenue Cumulative Bulletin V-2, Pages 16 to 20, inclusive. The computation follows:

Earned net income	$7,913.24
Less:	
Personal exemption	3,500.00
Earned income subject to normal tax	$4,413.24
Normal tax at 1½% on $4,000.00	$ 60.00
Normal tax at 3% on 413.24	12.40
	$ 72.40
Earned income credit (25% of $72.40)	18.10

Payment should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

Copy.

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[36] Filed May 31, 1929. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 43,432.

BROWN, ARTHUR M.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ANSWER.

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits the allegations contained in Paragraph 2 of the petition.

3. Admits the allegations contained in Paragraph 3 of the petition.

4. Denies that Commissioner committed error in the matter of increase of partnership (Edward Brown & Sons) income for 1926 in the amount of $1,947.77.

5. Denies that the Commissioner erred as alleged in subdivisions 5 (a) and 5 (b) of Paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation set forth in taxpayer's petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
PHILIP M. CLARK,
Special Attorney,
Bureau of Internal Revenue.
CCH/MT.

[37] 22 B. T. A. ——.

United States Board of Tax Appeals.

DOCKET Nos. 35,305, 39,157 and 43,432.

Promulgated March 11, 1931.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

FINDINGS OF FACT AND OPINION.

1. The respondent's determination that a certain payment of money made by the petitioner to his sister in 1923, was a capital expenditure and not deductible in computing the petitioner's net income for that year, sustained.

2. Overriding commissions, representing a percentage of the net premiums written during the month, paid monthly by fire insurance companies to their general agents, as compensation for carrying on the affairs of the insurance companies in the territory in which they represent such companies, are income of the year in which received and may not be allocated to subsequent years through which the policies written during the taxable year are to run.

3. A reserve set aside out of the taxable year's earnings, to cover refunds of overriding commissions which the general agent may be required to make to the insurance companies, in the event of the cancellation or reinsurance

in later years of business written during the taxable year, is a contingent liability and may not be deducted from gross income in arriving at taxable net income.

ARTHUR B. DUNNE, Esq., KENNETH N. LOGAN, C. P. A., for the Petitioner.

EUGENE MEACHAM, Esq., for the Respondent.

The petitioner seeks a redetermination of deficiencies in income taxes, asserted by the respondent for the years, and in the amounts, as follows:

A true copy:

[Seal] Teste: B. D. GAMBLE,
Clerk U. S. Board of Tax Appeals.

[38]

Docket No.	Year.	Deficiency.
35305	1923	$17,923.03
39157	1925	1,520.19
43432	1926	944.30

The petitioner alleges: (1) That the respondent erred in disallowing, as a deduction from business income for 1923, a payment of $3,000 made to petitioner's sister under a written agreement; and (2) that the income to petitioner's business for 1923, and to the successor partnership for 1925 and 1926, from commissions on insurance policies written, should be computed upon the basis of a *pro rata* apportionment of such commissions to the policy years; or, as an alternative, that the income from commissions should be computed by deducting from the gross commissions earned in each year, such an amount as the past experience of the business indicates will probably be refunded to insurance

companies on account of cancellation of policies. The proceedings were consolidated for hearing and decision.

FINDINGS OF FACT.

The petitioner, an individual, is a resident of the State of California.

From 1896 to 1904 the petitioner, his father, Edward Brown, and his brother, Herbert H. Brown, were engaged in business as general insurance agents. The senior Brown died in 1904, and until 1922 the business was carried on by the petitioner and Herbert H. Brown. The latter died in August, 1922, and throughout the remainder of 1922 and all of 1923 the business was conducted by the petitioner alone. On January 1, 1924, the [39] petitioner's son, Arthur M. Brown, Jr., was admitted as a partner, and throughout the taxable years 1925 and 1926 the business has been carried on by the partnership. During its entire existence the business has been carried on under the name of Edward Brown & Sons.

On June 1, 1902, Edward Brown, Herbert H. Brown, and the petitioner entered into a written agreement, as follows:

> Edward Brown, Arthur M. Brown and Herbert H. Brown, doing business under the firm name of EDWARD BROWN & SONS, as General Agents of Fire Insurance Companies, at 411–413 California Street, San Francisco, in the State of California, hereby agree and declare their respective interests in such business to be as follows:

After First setting apart and paying the sum of Two Hundred and Fifty Dollars ($250.00) per month as hereinafter provided for, the remaining profits to be divided as follows:

EDWARD BROWN to have four-tenths;

ARTHUR M. BROWN, to have four-tenths;

HERBERT H. BROWN to have two-tenths.

Bad debts and all other losses connected with the business to be borne by the several parties in like proportions.

Before any division of profits is made the said partners mutually agree to pay monthly to Jesse H. Jones, Edith H. Halton and Ethel Brown, (the three daughters of Edward Brown and Sisters of Arthur M. Brown and Herbert H. Brown), the sum of Two Hundred and Fifty Dollars ($250.00) and Further, that whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand Dollars per annum they will pay a one-sixth proportion of such excess to the said Jessie H. Jones, Edith H. Halton, and Ethel Brown.

They further agree that in the case of the Death of one or more members of the said firm his or their heirs or executors shall be paid annually, for a term not exceeding ten years from the date, of the death of such member or members, such proportion of the net profits of said firm as hereinafter is proportion,

[40] To the heirs or executors of EDWARD BROWN, one-tenth;

To the heirs or executors of ARTHUR M. BROWN, two-tenths;

To the heirs or executors of HERBERT H. BROWN, one-tenth;

Provided that should Herbert H. Brown die before marrying no payment shall be required to be made to his heirs or executors.

It is further agreed that monthly installments on account of the said proportionate interest or interests shall be made on demand to such heirs or executors.

Witness our hands the date and place above mentioned.

EDWARD BROWN.
ARTHUR M. BROWN.
HERBERT H. BROWN.

Edward Brown died in the year 1904. On May 27, 1905, a written agreement was executed by and between Arthur M. Brown and Herbert H. Brown as surviving members of the firm of Edward Brown & Sons, and as heirs and as executors of the will of Edward Brown, deceased; Henry Michaels as executor fo said will of Edward Brown, and Jessie H. Jones, Edith H. Halton and Ethel Crandell as heirs and residuary legatees and devisees under the will of said Edward Brown, deceased, and Irene W. Brown as the widow and heir, and as legatee under the will of Edward Brown, deceased. Said written agreement of May 27, 1905, cannot now be found and there is no evidence as to its contents.

Jessie H. Jones, one of the petitioner's three sisters who were mentioned in the agreement of

June 1, 1902, and who were parties to the agreement of May 27, 1905, died subsequent to the latter date and prior to May 28, 1907. On May 28, 1907, Edith H. Halton and Ethel Crandell, the two surviving sisters, executed a written agreement which reads as follows:

> [41] We, Edith H. Halton and Ethel Crandell, the undersigned, and each of us, and the survivor of us, do and does hereby consent and agree to accept from the firm of Edward Brown & Sons, General Fire Insurance Agents, San Francisco, California, the sum of Two Hundred and *fifth* ($250.00) Dollars per month, commencing with the month beginning June 1st, 1907, and ending only by mutual agreement in full satisfaction for all amounts which may be due, or may become due, to us, or either of us, or to the survivor of us, from said firm, under and by reason of the provisions of that certain Agreement dated May 27, 1905, by and between Arthur M. Brown and Herbert H. Brown as surviving members of said firm and as Heirs, and as Executors of the Will of Edward Brown, deceased; Henry Michaels, as Executor of said Will; and Jessie H. Jones, Edith H. Halton and Ethel Crandell, as Heirs, and as residuary legatees and devisees under the Will, of Edward Brown, deceased; and Irene W. Brown, as Widow and as Heir, and as a legatee under the Will, of Edward Brown, deceased; Provided that any further amounts to which we, or either of us, or the survivor of us, might

be entitled from said firm under said agreement shall be retained in the net profits of said firm as the property and to the credit of said Arthur M. Brown and Herbert H. Brown, members of said firm, to be divided between them as they may agree.

This agreement has never been modified in any particular. In 1923, the petitioner made a payment of $3,000 to his sister Edith H. Halton in accordance with the foregoing agreements, and claimed the same as a deduction from business income in his return for that year. The deduction has been disallowed by the respondent on the ground that the payment constituted a capital expenditure.

During the taxable years in controversy the firm of Edward Brown & Sons acted as general agents, in eleven Pacific coast and adjacent states, the territories of Alaska and Hawaii, the Philippine Islands, and the Province of British Columbia, for six fire insurance companies, namely: Hamilton Fire [42] Insurance Company, Globe & Rutgers Fire Insurance Company of New York City, Brand & Lifforsakrings Aktiebolaget Svea, Agricultural Insurance Company of Watertown, New York, Hudson Insurance Company of New York and United States Merchants & Shippers Insurance Company. The firm's relations with the two first mentioned companies were fixed by conversations with officers of those companies and the acts of the parties. Its relations with the other four companies were fixed by written agreements.

The duties required of and performed by the firm

were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; received and acknowledged service of proof of loss; issued, countersigned and cancelled policies; received and receipted for premiums, surveyed all risks offered and accepted or rejected the same; represented its principals on the Pacific Board of Fire Underwriters; computed and paid commissions due local agents; ceded or reinsured certain lines of business with treaty or other companies; computed and paid return premiums on cancelled policies; secured return of premium on cancelled reinsurance; rendered all reports required of its principals by the authorities of political subdivisions in the territory in which it operated; attended to the payment of all license fees and taxes; furnished all necessary printed matter, except policy blanks, to local agents; transferred insurance by endorsement; determined whether its principals should participate in special pools; and generally attended to all of the affairs of its principals in the territory in which it operated.

[43] Under the arrangements with the insurance companies it represented, the firm received, as compensation, a percentage of the net profits on business written in its territory, and so-called "overriding commissions" which are stated percentages of the net premiums written. By net premiums is meant gross premiums written less return premiums and net cost of reinsurance.

All policies written by the firm, since 1917, are

for periods of one, three, or five years, and contain provisions for cancellation by the insurance company or the assured. If the insurance company cancels, it is obligated to refund a ratable proportion of the premium for the unexpired term of the policy; if the assured cancels, the company is entitled to retain the customary short period rate for the time the policy has been in force.

All premiums on policies written by the firm are payable in advance, subject to the usual grace period of 60 days.

The firm makes remittances to the insurance companies on monthly balances, crediting itself with, among other things, the overriding commissions due on the business written during the month, and charging itself, among other things, a proportional part of any overriding commissions previously received in respect of any business which was cancelled, or reinsured in another company, during the month.

The following is a statement by five year periods, from 1919 to 1926, of gross fire premiums written by the firm, fire premiums cancelled, and ratio of premiums cancelled to gross premiums written, as shown by the firm's books of account:

[44]

Five Year Period	Gross fire premiums written	Fire premiums cancelled	Ratio
1919 to 1923	$14,893,022	$3,333,104	22.38%
1920 to 1924	15,647,482	3,492,101	22.32
1921 to 1925	15,931,443	3,432,670	21.55
1922 to 1926	17,155,359	3,624,071	21.13

The firm's books of account have been kept consistently on an accrual basis. Overriding commissions on new business have been accounted income of the year in which the business was written; and refunds of overriding commissions, on account of policy cancellations or reinsurance, have been accounted expense of the year of cancellation or reinsurance.

At the close of 1923, for the first time, a liability account denominated "Return Commissions" was set up on the firm's books. The purpose of the account was to record the firm's contingent liability to refund to insurance companies a portion of the overriding commissions received during the year, on account of future cancellations and the reinsurance of business written during the year. At the close of each of the years 1924 to 1926, inclusive, the credit balance in the account was adjusted to reflect the same proportion of the overriding commissions received during the year as the total fire premiums cancelled in the next preceding five year period bear to the gross fire premiums written in the same period.

In computing business income for 1923, the petitioner claimed a deduction of $52,971.96, the amount credited to the contingent liability account at the close of that year. In computing the partnership net income for 1925 and 1926 deductions of $3,292.98 and $1,947.77, respectively, were claimed, representing the net additions to the contingent liability account in those years. All three deductions have been disallowed by the respondent.

[45] OPINION.

MARQUETTE.—The first question presented by the record herein is whether the petitioner in computing his net income for 1923 is entitled to deduct the amount he paid to his sister Edith H. Halton in that year under the circumstances set forth in the findings of fact. The petitioner contends that the sister had an interest in the business of Edward Brown & Sons that antedated the death of Edward Brown, and that the amount paid to her represented her distributive share of the profits. The respondent has determined, and now maintains, that the payment to Edith H. Halton represented a capital expenditure by the petitioner.

On the record we cannot disturb the respondent's determination. The petitioner, his father and his brother entered into an agreement among themselves on June 1, 1902, providing for the payment of a certain part of the profits of the partnership to the three daughters of Edward Brown (the sisters of the petitioner). Edward Brown died in 1904 and on May 27, 1905, a written contract was executed by the petitioner and his brother as surviving members of the partnership and as heirs and executors of Edward Brown, deceased, and by their three sisters as heirs and legatees under the last will and testament of Edward Brown, that apparently superseded the agreement of June 1, 1902. What the contract of May 27, 1905, provided for or reserved to the daughters of Edward Brown, we do not know, but in any event the surviving

daughters agreed in writing on May 28, 1907, to accept $250 per month in satisfaction of all amounts "which may be due, or may become due, to us, or either of us, or to the survivor of us" from the firm of Edward Brown & Sons under the agreement of May 27, 1905. Since we are not [46] informed as to the terms of the contract of May 27, 1905, we are unable to determine what interest, if any, the sisters had in the business of Edward Brown & Sons under that agreement. Nor can we say, in the absence of that information, that the amount of $3,000 per year paid by the petitioner to his sister in 1923 pursuant to the agreement of June 1, 1907, was a capital expenditure. The respondent has determined that it was a capital expenditure and the burden is upon the petitioner to show otherwise, which he has failed to do.

The second issue is as to the proper method of treating the overriding commissions received by Edward Brown & Sons during the taxable years in controversy. The petitioner contends that they should be returned as income upon the basis of a *pro rata* apportionment of such commissions to the policy years. In other words the petitioner contends that as to overriding commissions received for writing one year policies, one-half should be returned as income of the year in which the policy was written and one-half as income of the next year; that as to commissions received for writing three year policies, one-sixth should be returned as income of the year in which the policy was written, one-third as income of each of the first and second

succeeding years, and one-sixth as income of the third succeeding year; and that as to commissions received for writing five year policies, one-tenth should be returned as income of the year in which the policy was written, one-fifth as income of each of the first, second, third and fourth succeeding years, and one-tenth as income of the fifth succeeding years. The method assumes that all policies written in any one year were issued as of the average date of July 1, and, in that [47] respect, resembles the method generally used by insurance companies for computing the unearned premium reserve.

It is to be observed that the method of computing overriding commissions income now contended for is not the method employed in keeping the firm's books of account. It has been the firm's consistent practice to account for overriding commissions on new business as income of the year in which the business was written; and any departure from that practice now can only be justified on the ground that net income will be more clearly reflected. Section 212 (b) Revenue Acts of 1921, 1924 and 1926.

It is argued in petitioner's behalf that the overriding commissions paid by the insurance companies to the firm of Edward Brown & Sons, in any one year, represent compensation for services rendered in that year and compensation for services to be rendered in later years while the policies, in respect of which the commissions were paid, continue in force; that such portion of the commissions as rep-

resents compensation for services to be rendered in later years cannot be considered as earned until the required services have been performed; and that the taxing statutes contemplate that a taxpayer keeping books on the accrual basis shall account for income only as it is actually earned.

The argument assumes much for which there is no support in the record. There is no proof that the overriding commissions contain any element of compensation for services to be rendered in future years. On that point the contracts are entirely silent; and there is no positive evidence that the payment of these commissions by the insurance companies created any obligation on the part of the firm to continue to render services while the policies continued in force. The firm made monthly settlements with the insurance [48] companies, withholding the overriding commissions to which it was entitled on the business written during the month. For aught that the written contracts provide, the firm could have ceased to do business following any one of such settlements without any obligation to render further services or to refund any part of the overriding commissions, except in the event of cancellation of any one of the policies prior to the ends of the terms for which they were written or in case of reinsurance of any part of the business covered by those policies.

The argument also assumes that the overriding commissions are paid solely for such services as may be required in connection with the procuring of new business and the adjustment of matters

arising out of the policy contracts. This is clearly not the case. The compensation provisions of the contracts, which base the compensation, in part, upon stated percentages of the net premiums written, provide merely the measure of the compensation to be paid the firm for carrying on all of the duties of a general agency. These duties include many which cannot be definitely related to any particular line of business, such as, the appointment and removal of local agents, representation of the firm's principals on the Pacific Board of Fire Underwriters, preparation and submission of reports required of the firm's principals by the authorities of political subdivisions in the territory in which the firm operates, attending to the payment of all fees, licenses and taxes, furnishing descriptive advertising to local agents, etc.; and for these duties the firm is compensated, in part, out of the overriding commissions.

[49] In our opinion, the overriding commissions withheld by the firm in its settlements with the insurance companies represent compensation for services rendered in the periods covered by those settlements, constitute earnings of those periods, and must be accounted for as income of the same periods. Cf. Automobile Underwriters, Inc., 19 B. T. A. 1160.

As an alternative, the petitioner seeks to compute its commission income by deducting from the gross commissions earned in each year, such an amount as the past experience of the business indicates will probably have to be refunded to insurance companies on account of cancellation of

policies and reinsurance with other companies, the amount to be deducted in each year being the same proportion of the gross commissions earned within the year as the total fire premiums cancelled during the preceding five-year period bears to the gross fire premiums written in the same period. This is merely an attempt to compute the income of the years in controversy upon a basis that will reflect the contingencies of the future. Essentially it is not different from the setting up of a reserve for future contingencies; and however certain it may appear, from the past experience of the business, that such contingencies will arise, such procedure is clearly not countenanced by the taxing statutes. William J. Ostheimer, 1 B. T. A. 18; Consolidated Asphalt Co., 1 B. T. A. 79; Uvalde Co., 1 B. T. A. 932; Thomas Cronin Co. v. Lewellyn, 9 Fed. (2d) 974; Pan-American Hide Co., 1 B. T. A. 1249; Morrison-Ricker Mfg. Co., 2 B. T. A. 1008; Thatcher Medicine Co., 3 B. T. A. 154; Greenville Coal Co., 3 B. T. A. 1323; H. Northwood & Co., 4 B. T. A. 697; [50] Lane Construction Corporation, 4 B. T. A. 1133; H. V. Greene Co., 5 B. T. A. 442; Liberty Agency Co., 5 B. T. A. 778; Farmers National Bank, 6 B. T. A. 1036; Frank J. Jewell, 6 B. T. A. 1040; Lehigh & Hudson River Railroad Co., 13 B. T. A. 1154; Lane Construction Corporation, 17 B. T. A. 826; Automobile Underwriters, Inc., *supra.* See, also, Consolidated Tea Co. vs. Bowers, 19 Fed. (2d) 382; and Malleable Iron Range Co. vs. United States, 62 Ct. Cls. 425.

Judgment will be entered under Rule 50.

[51] United States Board of Tax Appeals.

DOCKET No. 35,305.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION.

Pursuant to the findings of fact and opinion of the Board in the above-entitled proceedings promulgated March 11, 1931, the respondent has filed a motion for judgment in accordance with said findings of fact and opinion. Now, upon consideration thereof, it is

ORDERED AND DECIDED, upon redetermination, that the petitioner's deficiency in tax for the year 1923 is $17,923.03.

(Signed) JOHN J. MARQUETTE,
Member, United States Board of Tax Appeals.

Entered Apr. 25, 1931.

A true copy.

[Seal] Teste: B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

[52] United States Board of Tax Appeals

DOCKET No. 39,157.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION.

Pursuant to the findings of fact and opinion of the Board in the above-entitled proceedings promulgated March 11, 1931, the respondent has filed a motion for judgment in accordance with said findings of fact and opinion. Now, upon consideration thereof, it is

ORDERED AND DECIDED, upon redetermination, that the petitioner's deficiency in tax for the year 1925 is $1,520.19.

(Signed) JOHN J. MARQUETTE,
Member, United States Board of Tax Appeals.

Entered Apr. 25, 1931.

A true copy.

[Seal] Teste: B. D. GAMBLE,
Clerk U. S. Board of Tax Appeals.

[53] United States Board of Tax Appeals.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION.

Pursuant to the findings of fact and opinion of the Board in the above-entitled proceeding promulgated March 11, 1931, the respondent has filed a motion for judgment in accordance with the said findings of fact and opinion. Now, upon consideration thereof, it is

ORDERED AND DECIDED, upon redetermination, that the petitioner's deficiency in tax for the year 1926 is $944.30.

(Signed) JOHN J. MARQUETTE,
Member, United States Board of Tax Appeals.

Entered Apr. 25, 1931.

A true copy.

[Seal] Teste: B. D. GAMBLE,
Clerk U. S. Board of Tax Appeals.

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[54] Filed Aug. 27, 1931. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 35,305.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION AND ORDER RE CONSOLIDATION ON APPEAL.

Three separate matters having been pending before the United States Board of Tax Appeals, each entitled "Arthur M. Brown, Petitioner, against Commissioner of Internal Revenue, Respondent," and numbered on the files of the said United States Board of Tax Appeals respectively, Docket Numbers 35,305, 39,157 and 43,432; and

Said matters having come on for hearing upon the same date and before the same Member of said United States Board of Tax Appeals and by consent having been tried and heard and decided together, upon the same evidence,—

NOW, IT IS STIPULATED by the parties that should the petitioner in said three matters perfect an appeal from the decisions of the United States Board of Tax Appeals in said three named matters, and to the United States Circuit Court of Appeals for the Ninth Circuit, that said three matters may be

consolidated on appeal; that the petitioner for review need prepare and file but one statement of evidence as incident to said appeal and the preparation of a record therefor, which said statement of evidence shall serve and be considered in all of said three named matters and said three matters may be heard on one transcript on appeal which shall include said statement of evidence and in addition all steps and matters separately and severally appearing in each one of said three named proceedings and particularly, and agreeable to rule 38 [55] of the rules of the United States Circuit Court of Appeals for the Ninth Circuit, shall include in addition to said statement of evidence the docket entries of the proceedings before the Board in each of said three named proceedings, pleading before the Board in each of said three named proceedings, findings of fact, opinion and decision of the Board in each of said three named proceedings, petition for review in each of said three named proceedings, and any other papers or matters appearing in any of said proceedings pertinent to said petition for review and proper to be included in said transcript, and that the clerk in certifying to any papers or records to be forwarded to the Circuit Court of Appeals for the Ninth Circuit may include all papers necessary in any of said three named matters in a single transcript, and that said three named matters may be consolidated for hearing and determination

upon any proceeding to review the decision in any of said three named matters.

Dated ———, 1931.

(Signed) ARTHUR B. DUNNE,
Attorney and Counsel for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

(Signed) KENNETH N. LOGAN,
Accountant and Counsel for Petitioner,
1222 Balfour Building,
San Francisco, California.

(Signed) C. M. CHAREST,
F.,
General Counsel, Bureau of Internal Revenue,
For Respondent.

So ordered.

Dated: ———, 1931.

———,
Member.

———

[56] Filed Aug. 27, 1931. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 39,157.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION AND ORDER RE CONSOLIDATION ON APPEAL.

Three separate matters having been pending before the United States Board of Tax Appeals, each entitled "Arthur M. Brown, Petitioner, against Commissioner of Internal Revenue, Respondent," and numbered on the files of the said United States Board of Tax Appeals respectively, Docket Numbers 35,305, 39,157 and 43,432; and

Said matters having come on for hearing upon the same date and before the same Member of said United States Board of Tax Appeals and by consent having been tried and heard and decided together, upon the same evidence,—

NOW, IT IS STIPULATED by the parties that should the petitioner in said three matters perfect an appeal from the decisions of the United States Board of Tax Appeals in said three named matters, and to the United States Circuit Court of Appeals for the Ninth Circuit, that said three matters may be consolidated on appeal; that the petitioner for review need prepare and file but one statement of evidence as incident to said appeal and the preparation of a record therefor, which said statement of evidence shall serve and be considered in all of said three named matters and said three matters may be heard on one transcript on appeal which shall include said statement of evidence and in addition all steps and matters separately and severally appearing in each one of said three named proceedings and particularly, and agreeable to rule 38 [57]

of the rules of the United States Circuit Court of Appeals for the Ninth Circuit, shall include in addition to said statement of evidence the docket entries of the proceedings before the Board in each of said three named proceedings, pleadings before the Board in each of said three named proceedings, findings of fact, opinion and decision of the Board in each of said three named proceedings, petition for review in each of said three named proceedings, and any other papers or matters appearing in any of said proceedings pertinent to said petition for review and proper to be included in said transcript, and that the clerk in certifying to any papers or records to be forwarded to the Circuit Court of Appeals for the Ninth Circuit may include all papers necessary in any of said three named matters in a single transcript, and that said three named matters may be consolidated for hearing and determination upon any proceeding to review the decision in any of said three named matters.

Dated: ————, 1931.

(Signed) ARTHUR B. DUNNE,
Attorney and Counsel for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

(Signed) KENNETH N. LOGAN,
Accountant and Counsel for Petitioner,
1222 Balfour Building,
San Francisco, California.

(Signed) C. M. CHAREST,
General Counsel, Bureau of Internal Revenue,
For Respondent.

So ordered.
Dated: ———, 1931.

_____,
Member.

[58] Filed Aug. 27, 1931. United States Board of Tax Appeals.

United States Board of Tax Appeals.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION AND ORDER RE CONSOLIDATION ON APPEAL.

Three separate matters having been pending before the United States Board of Tax Appeals, each entitled "Arthur M. Brown, Petitioner, against Commissioner of Internal Revenue, Respondent," and numbered on the files of the said United States Board of Tax Appeals respectively, Docket Numbers 35,305, 39,157 and 43,432; and

Said matters having come on for hearing upon the same date and before the same Member of said United States Board of Tax Appeals and by consent having been tried and heard and decided together, upon the same evidence,—

NOW, IT IS STIPULATED by the parties that should the petitioner in said three matters perfect an appeal from the decisions of the United States Board of Tax Appeals in said three named matters, and to the United States Circuit Court of Appeals for the Ninth Circuit; that said three matters may be consolidated on appeal; that the petitioner for review need prepare and file but one statement of evidence as incident to said appeal and the preparation of a record therefor, which said statement of evidence shall serve and be considered in all of said three named matters and said three matters may be heard on one transcript on appeal which shall include said statement of evidence and in addition all steps and matters separately and severally appearing in each one of said three named proceedings and particularly, and agreeable to rule 38 [59] of the rules of the United States Circuit Court of Appeals for the Ninth Circuit, shall include in addition to said statement of evidence the docket entries of the proceedings before the Board in each of said three named proceedings, pleadings before the Board in each of said three named proceedings, findings of fact, opinion and decision of the Board in each of said three named proceedings, petition for review in each of said three named proceedings, and any other papers or matters appearing in any of said proceedings pertinent to said petition for review and proper to be included in said transcript, and that the Clerk in certifying to any papers or records to be forwarded to the Circuit Court of Appeals for the Ninth Circuit may in-

clude all papers necessary in any of said three named matters in a single transcript, and that said three named matters may be consolidated for hearing and determination upon any proceeding to review the decision in any of said three named matters.

Dated: ————, 1931.

(Signed) ARTHUR B. DUNNE,
Attorney and Counsel for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

(Signed) KENNETH N. LOGAN,
Accountant and Counsel for Petitioner,
1222 Balfour Building,
San Francisco, California.

(Signed) C. M. CHAREST,
General Counsel, Bureau of Internal Revenue,
For Respondent.

So ordered.

Dated: ————, 1931.

————————,
Member.

———

[60] Filed Sept. 8, 1931.

United States Board of Tax Appeals.

DOCKET No. 35,305.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW OF DECISION OF UNITED STATES BOARD OF TAX APPEALS BY UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Your petitioner, Arthur M. Brown, feeling himself aggrieved by the decision of the United States Board of Tax Appeals rendered and made herein and entered herein on the 25th day of April, 1931, redetermining a deficiency on the income tax (normal tax and surtax) of petitioner for the calendar year, 1928, in an amount of Seventeen Thousand Nine Hundred Twenty-three and 03/100 Dollars ($17,923.03), does hereby appeal from said decision and redetermination and does hereby petition that said decision and redetermination be reviewed pursuant to the statutes and [61] rules in such cases made and provided, and in that behalf respectfully shows as follows:

1. Petitioner is an individual, and petitioner is now, and at all times herein mentioned was, residing at San Francisco, State of California, and is now, and at all times herein mentioned was, an inhabitant of the State of California and of the Ninth of the Circuits established for the United States Circuit Court of Appeals. Petitioner, pursuant to the provisions of law in that behalf made and provided, duly filed with the Collector of Internal Revenue for the First District of California, at

San Francisco, California, his return of his income for the calendar year, 1923. Thereafter, the Honorable, the Commissioner of Internal Revenue, respondent herein, assessed against petitioner and on account of the income of petitioner for the calendar year, 1923, a deficiency. Thereafter, and within the time allowed by law, petitioner, feeling himself aggrieved by said determination, did, pursuant to the provisions of law in said cases made and provided, petition the Honorable, the United States Board of Tax Appeals, to review said determination. Respondent herein having appeared and answered said petition said matter did come on duly and regularly to be heard before the said, the Honorable, the United States Board of Tax Appeals, and thereafter, and on the 11th day of March, 1931, said, the Honorable, the United States [62] Board of Tax Appeals did promulgate and render and file its findings of fact and opinion herein in favor of respondent, and adverse to your petitioner, and thereafter, and upon motion of respondent for judgment, and on the 25th day of April, 1931, did, in accordance with said findings and opinion, render, make, file and enter herein, its decision and judgment ordering and deciding, upon redetermination, that the deficiency in the tax of petitioner for the year, 1923, is the sum of Seventeen Thousand Nine Hundred Twenty-three and 03/100 Dollars ($17,923.03).

2. Petitioner hereby seeks review of said determination and decision and judgment by the United

States Circuit Court of Appeals for the Ninth Circuit.

3. The nature of the controversy is as follows:

(a) The income of petitioner for the calendar year, 1923, and as to which there is a controversy, was derived by petitioner from the conduct at San Francisco, California, of the business of insurance general agent, conducted by him but as to which he asserts his sister, Edith H. Halton, had a participating interest. Said business was conducted under the fictitious name of "Edward Brown & Sons," and consisted in the representation, in all aspects of their business, of various insurance companies in the State of California, other western states of the United States, and elsewhere. From the proceeds of said business [63] for the year, 1923, petitioner paid to his sister, Edith H. Halton, the sum of Three Thousand Dollars ($3,000). Petitioner, in returning his income for the year, 1923, and in computing his own income, deducted this sum of Three Thousand Dollars ($3,000). This deduction respondent refused to allow. Petitioner asserted, and now asserts, that said payment made to his sister was made by reason of the fact that she had a limited interest in said business, and that the same was a joint venture as between himself and his said sister, and that said payment represented no more than the participation by his said sister in the profits of said business, by reason of her proprietary interest therein. Respondent disallowed said claim upon the ground asserted, that said sister of petitioner, Edith H. Halton, had

had a proprietary interest in said business, and that the same had been acquired by her said brother, your petitioner, in return for certain considerations consisting in yearly payments by petitioner to his said sister, and that said payment of Three Thousand Dollars ($3,000) was one of said yearly payments, made for the purpose of acquiring her asserted proprietary interest, and was not a proper deduction from income but was a capital expenditure.

(b) The business conducted by petitioner as aforesaid and on behalf of various insurance companies consisted in the management of the business of said companies, and, particularly, in the writing of insurance for them. The policies of insurance for said companies so written during the calendar year, 1923, and for [64] years prior thereto, and after 1923, were policies written for definite terms which said terms were one, three and five years. Part of the compensation paid to petitioner on account of said services rendered as aforesaid consisted in the payment to petitioner of a percentage of the premiums collected on such insurance written as aforesaid, which said percentage was determined by contract between petitioner and the insurance companies represented by him and for whom he acted. This was known as overriding commission. Upon cancellation of any insurance written as aforesaid before the expiration of a term for which the same was written, the unearned portion of the premium for insurance was required to be returned to the assured, and, accordingly, on such cancella-

tion by either the assured or the insurance company, and on the return of such premium, petitioner was required to refund such proportion of the overriding commission as the refunded part of the premium bore to the full premium. Long experience showed that the percentage of premiums refunded by reason of cancellation and consequent refund of overriding commission was between 21% and 23% during a given year. In making his return for the year, 1923, petitioner deducted from his income for that year Fifty-two Thousand Nine Hundred Seventy-one and 96/100 Dollars ($52,971.96) on account of return which would have to be made by him from overriding commissions paid to him by reason [65] of cancellation and consequent return of premium with respect to policies written by him during the calendar year, 1923. Such deduction was disallowed by the respondent, and the respondent now claims that the same is improper, by reason of the fact that no reserve can lawfully be set up in such manner, and by reason of the fact that the liability to return unearned overriding commission is contingent only. The books of petitioner for the calendar year, 1923, were kept on an accrual basis. Petitioner further asserts that the services for which said overriding commissions are paid are not completed upon writing of the policies, but extend and are performed throughout the whole of the life of each policy. Petitioner further asserts that if the foregoing method of returning overriding commission income is improper, that then he is entitled to return said in-

come, not on a cash basis and as received, but on an accrual basis and only as earned, and that, accordingly, his books being kept on an accrual basis, and his income being a percentage of premiums on policies written during the year, 1923, but for terms which will extend beyond 1923, he should return of such income for the year, 1923, only such portion thereof as is represented by the life of such policy during the year, 1923, and, consequently, only such portion thereof as is earned during the year, 1923; that his said income, being a percentage of premiums earned on policies, is earned only over the life of the policy, as is the [66] premium, and, accordingly, in any one year only such proportion should be returned as corresponds to the life of the policy in said particular year and is earned in said year. Respondent contended that overriding commission income should be returned in the year in which received, irrespective of the nature of the policy or policies on the premiums of which it was computed, and that to return it as earned would be to return it in a method not followed in keeping the books of account of petitioner.

4. Your petitioner respectfully assigns as error committed by the Honorable, the United States Board of Tax Appeals, in the hearing and determination of the above-entitled matter, the following:

(a) Error in determining that there was any deficiency as to the tax due from petitioner and on account of income of petitioner for the year, 1923, and in failing to find and determine that there was

no deficiency due from petitioner on account of the income and surtax of petitioner with respect to the income of petitioner for the year, 1923.

(b) Error in determining that the Three Thousand Dollars ($3,000) paid by petitioner to Edith H. Halton, as hereinbefore set out, was not a proper deduction in computing the gross income and the net income of petitioner for the year, 1923, and in determining that the same was a capital expenditure.

[67] (c) Error in determining that the Fifty-two Thousand Nine Hundred Seventy-one and 96/100 Dollars ($52,971.96) deducted by petitioner in computing petitioner's taxable income for the year, 1923, and deducted on account of petitioner's liability to return overriding commission income by reason of cancellation of policies, was not a proper deduction.

(d) Error in determining that the figure Fifty-two Thousand Nine Hundred Seventy-one and 96/100 Dollars ($52,971.96), or any other figure set up as a deduction by reason of liability to return overriding commissions received, by reason of cancellation of policies on the premiums of which said overriding commission was computed, was not a proper deduction and was in substance a reserve against future contingencies.

(e) Error in determining that however certain it may appear from past experience of a business that contingencies will arise requiring an outlay and return of an income, a procedure of setting up a fund to meet such liability is not countenanced by the taxing statutes.

(f) Error in determining that petitioner's overriding commission income, being a percentage of the premiums of policies written by petitioner, was earned when received, and in determining that the same was not earned over the life of the policy to which the same related, and on the premium of which the same was computed and was only so earned.

[68] (g) Error in determining that overriding commission income of petitioner was earned when received and must be returned for the year in which the same was received, and could not be returned as earned over the lives of the policies on the premiums of which the same was computed.

(h) Error in determining that to return overriding commission income on an accrual basis, and to return the same as earned, and to return the same on the basis that it was earned over the life of the policies on the premiums of which it was computed, was to return the income of petitioner by a method different from the method used in keeping the books of petitioner and different from the method shown on the books of petitioner.

(i) As to each of the foregoing determinations specified to have been erroneous, petitioner further specifies that each and every one thereof was unsupported and is unsupported by the evidence.

(j) Error in rejecting petitioner's offer of the reports of the internal revenue agent with respect to the income of petitioner for the year, 1923, being Petitioner's Exhibit No. 17, for identification, and in striking out a portion thereof theretofore re-

ceived in evidence, and stating that the accounts in connection with the general insurance agency of taxpayer may be said to be kept on an accrual basis.

[69] (k) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 26 for identification.

(l) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 28 for identification.

WHEREFORE, petitioner prays:

1. That a record of all of the proceedings herein be made up and certified to the United States Circuit Court of Appeals for the Ninth Circuit, and that this appeal be allowed, and that said court review the action and determination of the United States Board of Tax Appeals in this cause.

2. That it be determined that there is no deficiency due on account of the income tax or surtax of petitioner, and with respect to the income of petitioner for the year, 1923, and that the determination of the United States Board of Tax Appeals in that behalf be vacated.

3. That it be determined that the Three Thousand Dollars ($3,000) paid by said petitioner to Edith H. Halton is a proper deduction in the computation of the tax of petitioner as aforesaid.

4. That petitioner be permitted, in returning his income, to return overriding commission income, not as received but as earned.

5. That in the event overriding commission income is not to be returned as earned, that then

petitioner, in computing [70] his income for purposes of taxation, be permitted to deduct from gross overriding commission income received in any one year the liability incident thereto, to return a portion thereof on cancellation of policies on the premiums of which the said commission was computed.

6. That the errors hereinbefore assigned be corrected and judgment entered accordingly.

7. For such other, further and different relief as, the premises considered, is proper.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

[71] State of California,
City and County of San Francisco,—ss.

Arthur M. Brown, being first duly sworn, deposes and says:

That he is the petitioner named in the foregoing petition; that he has read the foregoing petition, and knows the contents thereof, and that the same is true of his own knowledge, except as to matters therein stated on information or belief, and that as to those matters he believes it to be true; that the same is not filed for purposes of delay, and that he verily believes that he is justly entitled to the relief sought.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 3d day of September, 1931.

[Notarial Seal] KATHRYN E. STONE,
Notary Public in and for the City and County of San Francisco, State of California.
My commission expires March 1, 1933.

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[72] Filed Sept. 9, 1931.

United States Board of Tax Appeals.

DOCKET No. 35,305.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

NOTICE OF FILING OF PETITION FOR REVIEW.

To the Honorable, the Commissioner of Internal Revenue, Respondent Above Named, Washington, D. C., and to His Attorney:

You are hereby notified that on the 8th day of September, 1931, petitioner above named filed with the United States Board of Tax Appeals, his petition for review of the decision of the United States Board of Tax Appeals, in the above-entitled cause, entered herein on the 25th day of April, 1931, redetermining a deficiency in the taxes of petitioner for the year 1925, by the United States Circuit

Court of Appeals for the Ninth Circuit, and that attached hereto is a copy of said petition.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Bldg.,
San Francisco, California.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

[73] Due service of the foregoing notice and attached copy of petition and receipt of copies thereof is hereby admitted this 9th day of September, 1931.

_____,
Commissioner of Internal Revenue.
By C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

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[74] Filed Sept. 8, 1931.

United States Board of Tax Appeals.

DOCKET No. 39,157.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW OF DECISION OF UNITED STATES BOARD OF TAX APPEALS BY UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Your petitioner, Arthur M. Brown, feeling himself aggrieved by the decision of the United States Board of Tax Appeals rendered and made herein and entered herein on the 25th day of April, 1931, redetermining a deficiency on the income tax (normal tax and surtax) of petitioner for the calendar year, 1925, in an amount of One Thousand Five Hundred Twenty and 19/100 Dollars ($1,520.19), does hereby appeal from said decision and redetermination and does hereby petition that said decision and redetermination be reviewed pursuant to the statutes and rules in such [75] cases made and provided, and in that behalf respectfully shows as follows:

1. Petitioner is an individual, and petitioner is now, and at all times herein mentioned was, residing at San Francisco, State of California, and is now, and at all times herein mentioned was, an inhabitant of the State of California and of the Ninth of the Circuits established for the United States Circuit Courts of Appeals. Petitioner, pursuant to the provisions of law in that behalf made and provided, duly filed with the Collector of Inter-

nal Revenue for the First District of California, at San Francisco, California, his return of his income for the calendar year, 1925. Thereafter, the Honorable, the Commissioner of Internal Revenue, respondent herein, assessed against petitioner and on account of the income of petitioner for the calendar year, 1925, a deficiency. Thereafter, and within the time allowed by law, petitioner, feeling himself aggrieved by said determination, did, pursuant to the provisions of law in said cases made and provided, petition the Honorable, the United States Board of Tax Appeals, to review said determination. Respondent herein having appeared and answered said petition said matter did come on duly and regularly to be heard before the said the Honorable, the United States Board of Tax Appeals, and thereafter, and on the 11th day of March, 1931, said, the Honorable, the United [76] States Board of Tax Appeals did promulgate and render and file its findings of fact and opinion herein in favor of respondent, and adverse to your petitioner, and thereafter, and upon motion of respondent for judgment, and on the 25th day of April, 1931, did, in accordance with said findings and opinion, render, make, file and enter herein, its decision and judgment ordering and deciding, upon redetermination, that the deficiency in the tax of petitioner for the year, 1925, is the sum of One Thousand Five Hundred Twenty and 19/100 Dollars ($1,520.19).

2. Petitioner hereby seeks review of said determination and decision and judgment by the United

States Circuit Court of Appeals for the Ninth Circuit.

3. The nature of the controversy is as follows:

During the year, 1925, petitioner and his son, Arthur M. Brown, Jr., as copartners, conducted a general insurance agency business under the fictitious name of "Edward Brown & Sons," and the income of petitioner for the year, 1925, as to which there is a controversy, was the petitioner's share of the income of said partnership derived from "overriding commissions" on account of said business. The business conducted as aforesaid and on behalf of various insurance companies consisted in the management of the business of said companies, and, particularly, in the writing of insurance for them. The policies of insurance [77] for said companies so written during the calendar year, 1925, and for years prior thereto, and after 1925, were policies written for definite terms which said terms were one, three and five years. Part of the compensation paid on account of said services rendered as aforesaid consisted in the payment of a percentage of the premiums collected in such insurance written as aforesaid, which said percentage was determined by contract between said partnership and the insurance companies represented by it and for whom it acted. This was known as overriding commission. Upon cancellation of any insurance written as aforesaid before the expiration of a term for which the same was written, the unearned portion of the premium for insurance was required to be returned to the assured, and, ac-

cordingly, on such cancellation by either the assured or the insurance company, and on the return of such premium, there was required to be refunded such proportion of the overriding commission as the refunded part of the premium bore to the full premium. Long experience showed that the percentage of premiums refunded by reason of cancellation and consequent refund of overriding commission was between 21% and 23% during a given year. In making his return for the year, 1925, petitioner deducted in computing said partnership's net income for that year Three Thousand Two Hundred Ninety-two and 98/100 Dollars ($3,292.98) on account of return which would have to be made from overriding commissions paid by reason of cancellation and consequent return of premium with respect to [78] policies written during the calendar year, 1925. Such deduction was disallowed by the respondent, and the respondent now claims that the same is improper, by reason of the fact that no reserve can lawfully be set up in such manner, and by reason of the fact that the liability to return unearned overriding commission is contingent only. The books of said partnership for the calendar year, 1925, were kept on an accrual basis. Petitioner further asserts that the services for which said overriding commissions are paid are not completed upon writing of the policies, but extend and are performed throughout the whole of the life of each policy. Petitioner further asserts that if the foregoing method of returning overriding commission income is improper, that then he

is entitled to return said income, not on a cash basis and as received, but on an accrual basis and only as earned, and that, accordingly, the books being kept on an accrual basis, and his income being a percentage of premiums on policies written during the year, 1925, but for terms which will extend beyond 1925, he should return of such income for the year, 1925, only such portion thereof as is represented by the life of such policy during the year, 1925, and, consequently, only such portion thereof as is earned during the year, 1925; that his said income, being a percentage of premiums earned on policies, is earned only over the life of the policy, as is the premium, and, accordingly, in any one year only such proportion should be returned as corresponds to the life of the policy in said particular year and is earned in said year. Respondent [79] contended that overriding commission income should be returned in the year in which received, irrespective of the nature of the policy or policies on the premiums of which it was computed, and that to return it as earned would be to return it in a method not followed in keeping the books of account of petitioner.

4. Your petitioner respectfully assigns as error committed by the Honorable, the United States Board of Tax Appeals, in the hearing and determination of the above-entitled matter, the following:

(a) Error in determining that there was any deficiency as to the tax due from petitioner and on account of income of petitioner for the year, 1925, and in failing to find and determine that there was

no deficiency due from petitioner on account of the income and surtax of petitioner with respect to the income of petitioner for the year, 1925.

(b) Error in determining that the Three Thousand Two Hundred Ninety-two and 98/100 Dollars ($3,292.98) deducted by petitioner in computing the said partnership's taxable income for the year, 1925, and deducted on account of liability to return overriding commission income by reason of cancellation of policies, was not a proper deduction.

(c) Error in determining that the figure Three Thousand Two Hundred Ninety-two and 98/100 Dollars ($3,292.98), or any other figure set up as a deduction by reason of liability [80] to return overriding commissions received, by reason of cancellation of policies on the premiums of which said overriding commission was computed, was not a proper deduction and was in substance only a reserve against future contingencies.

(d) Error in determining that however certain it may appear from past experience of a business that contingencies will arise requiring an outlay and return of an income, a procedure of setting up a fund to meet such liability is not countenanced by the taxing statutes.

(e) Error in determining that petitioner's overriding commission income, being a percentage of the premiums of policies written by petitioner, was earned when received, and in determining that the same was not earned over the life of the policy to which the same related, and on the premiums of

which the same was computed and was only so earned.

(f) Error in determining that overriding commission income of petitioner was earned when received and must be returned for the year in which the same was received, and could not be returned as earned over the lives of the policies on the premiums of which the same was computed.

(g) Error in determining that to return overriding commission income on an accrual basis, and to return the same as earned, and to return the same on the basis that it was earned over the life of the policies on the premiums of which it was computed, [81] was to return the income of petitioner by a method different from the method used in keeping the books of petitioner and different from the method shown on the books of petitioner.

(h) As to each of the foregoing determinations specified to have been erroneous, petitioner further specifies that each and every one thereof was unsupported and is unsupported by the evidence.

(i) Error in rejecting petitioner's offer of the reports of the internal revenue agent with respect to the income of petitioner for the year, 1925, being Petitioner's Exhibit No. 18, for identification, and in striking out a portion thereof theretofore received in evidence, and stating that the accounts in connection with the general insurance agency of taxpayer may be said to be kept on an accrual basis.

(j) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 26 for identification.

(k) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 28 for identification.

WHEREFORE, petitioner prays:

1. That a record of all of the proceedings herein be made up and certified to the United States Circuit Court of Appeals for the Ninth Circuit, and that this appeal be allowed, and that said court review the action and determination of [82] the United States Board of Tax Appeals in this cause.

2. That it be determined that there is no deficiency due on account of the income tax or surtax of petitioner, and with respect to the income of petitioner for the year, 1925, and that the determination of the United States Board of Tax Appeals in that behalf be vacated.

3. That petitioner be permitted, in returning his income, to return overriding commission income, not as received but as earned.

4. That in the event overriding commission income is not to be returned as earned, that then petitioner, in computing his income for purposes of taxation, be permitted to deduct from gross overriding commission income received in any one year the liability incident thereto, to return a portion thereof on cancellation of policies on the premiums of which the said commission was computed.

5. That the errors hereinbefore assigned be corrected and judgment entered accordingly.

6. For such other, further and different relief as, the premises considered, is proper.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

[83] State of California,
City and County of San Francisco,—ss.

Arthur M. Brown, being first duly sworn, deposes and says:

That he is the petitioner named in the foregoing petition; that he has read the foregoing petition, and knows the contents thereof, and that the same is true of his own knowledge, except as to matters therein stated on information or belief, and that as to those matters he believes it to be true; that the same is not filed for purposes of delay, and that he verily believes that he is justly entitled to the relief sought.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 3d day of September, 1931.

[Notarial Seal] KATHRYN E. STONE,
Notary Public in and for the City and County of San Francisco, State of California.
My commission expires March 1, 1933.

[84] Filed Sept. 9, 1931.

United States Board of Tax Appeals.

DOCKET No. 39,157.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

NOTICE OF FILING OF PETITION FOR REVIEW.

To the Honorable, the Commissioner of Internal Revenue, Respondent Above Named, Washington, D. C., and to His Attorney:

You are hereby notified that on the 8th day of September, 1931, petitioner above named filed with the United States Board of Tax Appeals, his petition for review of the decision of the said United States Board of Tax Appeals, in the above-entitled cause, entered herein on the 25th day of April, 1931, redetermining a deficiency in the taxes of petitioner for the year, 1925, by the United States Circuit Court of Appeals for the Ninth Circuit, and that attached hereto is a copy of said petition.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, Cal.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco, Cal.

[85] Due service of the foregoing notice and attached copy of petition and receipt of copies thereof, is hereby admitted this 9th day of September, 1931.

_____,

Commissioner of Internal Revenue,
By C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

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[86] Filed Sept. 8, 1931.

United States Board of Tax Appeals.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW OF DECISION OF UNITED STATES BOARD OF TAX APPEALS BY UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Your petitioner, Arthur M. Brown, feeling himself aggrieved by the decision of the United States Board of Tax Appeals rendered and made herein and entered herein on the 25th day of April, 1931, redetermining a deficiency on the income tax (nor-

mal tax and surtax) of petitioner for the calendar year, 1926, in an amount of Nine Hundred Forty-four and 30/100 Dollars ($944.30), does hereby appeal from said decision and redetermination and does hereby petition that said decision and redetermination be reviewed [87] pursuant to the statutes and rules in such cases made and provided, and in that behalf respectfully shows as follows:

1. Petitioner is an individual, and petitioner is now, and at all times herein mentioned was, residing at San Francisco, State of California, and is now, and at all times herein mentioned was, an inhabitant of the State of California and of the Ninth of the Circuits established for the United States Circuit Courts of Appeals. Petitioner, pursuant to the provisions of law in that behalf made and provided, duly filed with the Collector of Internal Revenue for the First District of California, at San Francisco, California, his return of his income for the calendar year, 1926. Thereafter, the Honorable, the Commissioner of Internal Revenue, respondent herein, assessed against petitioner and on account of the income of petitioner for the calendar year, 1926, a deficiency. Thereafter, and within the time allowed by law, petitioner, feeling himself aggrieved by said determination, did, pursuant to the provisions of law in said cases made and provided, petition the Honorable, the United States Board of Tax Appeals, to review said determination. Respondent herein having appeared and answered said petition said matter did come on duly and regularly to be heard before the said,

the Honorable, the United States Board of Tax Appeals, and thereafter, and on the 11th day of March, 1931, said, the Honorable, the United States Board of [88] Tax Appeals did promulgate and render and file its findings of fact and opinion herein in favor of respondent, and adverse to your petitioner, and thereafter, and upon motion of respondent, for judgment, and on the 25th day of April, 1931, did, in accordance with said findings and opinion, render, make, file and enter herein, its decision and judgment ordering and deciding, upon redetermination, that the deficiency in the tax of petitioner for the year, 1926, is the sum of Nine Hundred and Forty-four and 30/100 Dollars ($944.30).

2. Petitioner hereby seeks review of said determination and decision and judgment by the United States Circuit Court of Appeals for the Ninth Circuit.

3. The nature of the controversy is as follows:

During the year 1926, petitioner and his son, Arthur M. Brown, Jr., as copartners, conducted a general insurance agency business under the fictitious name of "Edward Brown & Sons," and the income of petitioner for the year, 1926, as to which there is a controversy, was the petitioner's share of the income of said partnership derived from "overriding commissions" on account of said business. The business conducted as aforesaid and on behalf of various insurance companies consisted in the management of the business of said companies, and, particularly, in the writing of insurance for them. The policies of insurance for said companies so written during

calendar year, 1926, and for years prior thereto, [89] and after 1926, were policies written for definite terms which said terms were one, three and five years. Part of the compensation paid on account of said services rendered as aforesaid consisted in the payment of a percentage of the premiums collected on such insurance written as aforesaid, which said percentage was determined by the contract between said partnership and the insurance companies represented by it and for whom it acted. This was known as overriding commission. Upon cancellation of any insurance written as aforesaid before the expiration of a term for which the same was written, the unearned portion of the premium for insurance was required to be returned to the assured, and, accordingly, on such cancellation by either the assured or the insurance company, and on the return of such premium, there was required to be refunded such proportion of the overriding commission as the refunded part of the premium bore to the full premium. Long experience showed that the percentage of premiums refunded by reason of cancellation and consequent refund of overriding commission was between 21% and 23% during a given year. In making his return for the year, 1926, petitioner deducted in computing said partnership's net income for that year One Thousand Nine Hundred Forty-seven and 77/100 Dollars ($1,947.77) on account of return which would have to be made from overriding commissions paid by reason of cancellation and consequent return of premium with respect to policies written during

the calendar year, 1926. [90] Such deduction was disallowed by the respondent, and the respondent now claims that the same is improper, by reason of the fact that no reserve can lawfully be set up in such manner, and by reason of the fact that the liability to return unearned overriding commission is contingent only. The books of said partnership for the calendar year, 1926, were kept on an accrual basis. Petitioner further asserts that the services for which said overriding commissions are paid are not completed upon writing of the policies, but extend and are performed throughout the whole of the life of each policy. Petitioner further asserts that if the foregoing method of returning overriding commission income is improper, that then he is entitled to return said income, not on a cash basis and as received, but on an accrual basis and only as earned, and that accordingly, the books being kept on an accrual basis, and his income being a percentage of premiums on policies written during the year 1926, but for terms which will extend beyond 1926, he should return of such income for the year 1926, only such portion thereof as is represented by the life of such policy during the year, 1926, and, consequently, only such portion thereof as is earned during the year 1926; that his said income, being a percentage of premiums earned on policies, is earned only over the life of the policy, as is the premium, and, accordingly, in any one year only such proportion should be returned as corresponds to the life of the policy in said particular year and is earned in said year. Respon-

dent contended that overriding commission [91] income should be returned in the year in which received, irrespective of the nature of the policy or policies on the premiums of which it was computed, and that to return it as earned would be to return it in a method not followed in keeping the books of account of petitioner.

4. Your petitioner respectfully assigns as error committed by the Honorable, the United States Board of Tax Appeals, in the hearing and determination of the above-entitled matter, the following:

(a) Error in determining that there was any deficiency as to the tax due from petitioner and on account of income of petitioner for the year 1926, and in failing to find and determine that there was no deficiency due from petitioner on account of the income and surtax of petitioner with respect to the income of petitioner for the year 1926.

(b) Error in determining that the One Thousand Nine Hundred Forty-seven and 77/100 Dollars ($1,947.77) deducted by petitioner in computing the said partnership's taxable income for the year 1926, and deducted on account of liability to return overriding commission income by reason of cancellation of policies, was not a proper deduction.

(c) Error in determining that the figure One Thousand Nine Hundred Forty-seven and 77/100 Dollars ($1,947.77), or any other figure set up as a deduction by reason of liability [92] to return overriding commissions received, by reason of cancellation of policies on the premiums of which said overriding commission was computed, was not a

proper deduction and was in substance only a reserve against future contingencies.

(d) Error in determining that however certain it may appear from past experience of a business that contingencies will arise requiring an outlay and return of an income, a procedure of setting up a fund to meet such liability is not countenanced by the taxing statutes.

(e) Error in determining that petitioner's overriding commission income, being a percentage of the premiums of policies written by petitioner, was earned when received, and in determining that the same was not earned over the life of the policy to which the same related, and on the premiums of which the same was computed and was only so earned.

(f) Error in determining that overriding commission income of petitioner was earned when received and must be returned for the year in which the same was received, and could not be returned as earned over the lives of the policies on the premiums of which the same was computed.

(g) Error in determining that to return overriding commission income on an accrual basis, and to return the same as earned, and to return the same on the basis that it was earned over the life of the policies on the premiums of which it was computed, [93] was to return the income of petitioner by a method different from the method used in keeping the books of petitioner and different from the method shown on the books of petitioner.

(h) As to each of the foregoing determinations

specified to have been erroneous, petitioner further specifies that each and every one thereof was unsupported and is unsupported by the evidence.

(i) Error in rejecting petitioner's offer of the reports of the internal revenue agent with respect to the income of petitioner for the year 1926, being Petitioner's Exhibit No. 19 for identification, and in striking out a portion thereof theretofore received in evidence, and stating that the accounts in connection with the general insurance agency of taxpayer may be said to be kept on an accrual basis.

(j) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 26 for identification.

(k) Error in rejecting evidence offered by petitioner, to wit, Petitioner's Exhibit No. 28 for identification.

WHEREFORE, petitioner prays:

1. That a record of all of the proceedings herein be made up and certified to the United States Circuit Court of Appeals for the Ninth Circuit, and that this appeal be allowed, and that said court review the action and determination of [94] the United States Board of Tax Appeals in this cause.

2. That it be determined that there is no deficiency due on account of the income tax or surtax of petitioner, and with respect to the income of petitioner for the year, 1926, and that the determination of the United States Board of Tax Appeals in that behalf be vacated.

3. That petitioner be permitted, in returning his

income, to return overriding commission income, not as received but as earned.

4. That in the event overriding commission income is not to be returned as earned, that then petitioner, in computing his income for the purposes of taxation, be permitted to deduct from gross overriding commission income received in any one year the liability incident thereto, to return a portion thereof on cancellation of policies on the premiums of which the said commission was computed.

5. That the errors hereinbefore assigned be corrected and judgment entered accordingly.

6. For such other, further and different relief as, the premises considered, is proper.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

[95] State of California,
City and County of San Francisco,—ss.

Arthur M. Brown, being first duly sworn, deposes and says:

That he is the petitioner named in the foregoing petition; that he has read the foregoing petition, and knows the contents thereof, and that the same is true of his own knowledge, except as to matters therein stated on information or belief, and that as to those matters he believes it to be true; that

the same is not filed for the purposes of delay, and that he verily believes that he is justly entitled to the relief sought.

ARTHUR M. BROWN.

Subscribed and sworn to before me this 3d day of September, 1931.

[Notarial Seal] KATHRYN E. STONE,
Notary Public in and for the City and County of San Francisco, State of California.
My commission expires March 1, 1933.

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[96] Filed Sept. 9, 1931.

United States Board of Tax Appeals.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

NOTICE OF FILING OF PETITION FOR REVIEW.

To the Honorable Commissioner of Internal Revenue, Respondent Above Named, Washington, D. C., and to His Attorney:

You are hereby notified that on the 8th day of September, 1931, petitioner above named filed with the United States Board of Tax Appeals, his petition

for review of the decision of the said United States Board of Tax Appeals, in the above-entitled cause, entered herein on the 25th day of April, 1931, redetermining a deficiency in the taxes of petitioner for the year 1926, by the United States Circuit Court of Appeals for the Ninth Circuit, and that attached hereto is a copy of said petition.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.

KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

[97] The service of the foregoing notice and attached copy of petition and receipt of copies thereof is hereby admitted this 9th day of September, 1931.

_____,
Commissioner of Internal Revenue.
By C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

[98] Filed Jan. 21, 1932.

United States Board of Tax Appeals.

Three proceedings, entitled as here, and numbered respectively as follows:

DOCKET No. 35,305.
DOCKET No. 39,157.
DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CONSOLIDATED STATEMENT OF EVIDENCE.

BE IT REMEMBERED that the petitioner above named having filed with the United States Board of Tax Appeals three separate petitions for determination of the tax liability of petitioner to the United States of America on account of the normal income tax and surtax of petitioner for the years 1923, 1925 and 1926, which said petitions and proceedings started thereby were entitled as above, and numbered on the files of the said United States Board of Tax Appeals respectively, Docket Nos. 35,305, 39,157 and 43,432; and respondent above named having filed his separate answer to each of said petitions, said three causes came on duly and regularly to be heard before the said United States

Board of Tax Appeals, Honorable John J. [99] Marquette, Member, presiding, at San Francisco, California, on the 14th day of May, 1930 petitioner appearing in person and by Arthur B. Dunne, Esq., his attorney, and Mr. Kenneth N. Logan, C. P. A., and respondent appearing by his attorneys, Clarence M. Charest, Esq., General Counsel, Bureau of Internal Revenue, and Eugene Meacham, Esq. Thereupon, on motion of counsel for petitioner, and by consent of counsel for respondent, it was ordered that said three causes be consolidated for hearing and decision. Thereafter, and on the 11th day of March, 1931, the United States Board of Tax Appeals promulgated and filed herein its findings of fact and opinion in said three causes, in favor of respondent and adverse to petitioner, and thereafter, and on the 25th day of April, 1931, on motion of respondent for judgment in accordance therewith, entered in each of said causes its decision and judgment in accordance with said findings of fact and opinion. Thereafter, by stipulation between the parties, said stipulation being in writing and being filed in each of said causes, it was stipulated that should petitioner above named perfect an appeal from said decisions, and to the United States Circuit Court of Appeals for the Ninth Circuit, that then said three causes be consolidated on appeal, and that petitioner for review need prepare and file but one statement of evidence as incident to said appeal and the preparation of a record therefor, which said statement of evidence should serve and be considered in all of said [100] three causes.

Accordingly, and the petitioner having heretofore duly served and filed his petitions for review of said decisions aforesaid, and his notice of filing of said petitions for review, in each of said three named causes, presents this his consolidated statement of evidence in said causes as follows:

Said causes coming on to be heard as aforesaid and having been consolidated as aforesaid, the following proceedings and none other were had, and the following evidence and none other was introduced, and the following is a full, true and correct statement of all matters, happenings and showings before the United States Board of Tax Appeals on its hearing and determination of said causes, and each of them, excepting only the pleadings in said causes, respectively:

Counsel for petitioner made an opening statement as to what petitioner expected to prove, and in the course of said statement stated that one of the items in controversy was a deduction made by petitioner from the income of petitioner, which deduction was a figure representing the liability of petitioner to return overriding commission received by reason of cancellation of policies on the premiums of which the commission had been computed, and it was stipulated that 1923 was the first year in which this was done. Counsel for respondent then made an opening statement, and petitioner then offered and introduced the following evidence:

TESTIMONY OF W. H. GIBBONS, FOR PETITIONER.

[101] W. H. GIBBONS, called as a witness on behalf of petitioner, being first duly sworn, testified as follows:

Direct Examination by Mr. DUNNE.

Edward Brown & Sons, up to 1922, was a partnership composed of Arthur M. Brown and his brother, Herbert H. Brown. Thereafter, for a short time, it was Arthur M. Brown, doing business under the name of Edward Brown & Sons, and thereafter was a partnership of Arthur M. Brown and his son, Arthur M. Brown, Jr. During 1918 and following I was with that organization as Superintendent of Agencies, became Assistant General Agent, and I was in charge of the underwriting department. I am familiar with the form of policies written by the companies represented by Edward Brown & Sons throughout the territory represented by them. In California the fire policy used is the California Standard Form, exclusively. In Oregon fire inance is written on the Oregon Standard Fire Insurance Policy. We use the old New York Standdard Form in Washington, Montana, Utah and Nevada, and the new New York Standard Form in Wyoming, Colorado, New Mexico, the Hawaiian Islands and Alaska. Of these forms now shown me the one on top is the old New York Standard Form and the second one is the California form. The conditions on the Oregon policy are the old New

(Testimony of W. H. Gibbons.)

York form. With reference to the part [102] of the policy as to cancellation there has been no change in those provisions in the policies written by Edward Brown & Sons since 1917; no change as to calculating the return premium, nor with respect to the right of the assured to cancel, nor with respect to the right of the insurance company to cancel. They all contain the provision that the assured can cancel upon the customary short rate. These policies are all cancellable either by the assured on the short rate basis or by the company on the prorated basis.

Thereupon, the three policies referred to were offered and received in evidence as Petitioner's Exhibit No. 1, were so marked, and so far as they are material here were and are as follows:

PETITIONERS' EXHIBIT No. 1.

"STOCK COMPANY

"STANDARD FIRE INSURANCE POLICY.

"The Globe & Rutgers Fire Insurance Company * * * In consideration of the stipulations herein named and of ——— Dollars premium does insure ——— for the term of ——— * * * against all direct loss or damage by fire, except as hereinafter provided, to an amount not exceeding ——— Dollars to the following described property while located and contained as described herein, and not elsewhere, to-wit:

(Space for Description.)

"This policy is made and accepted subject to the

foregoing stipulations and conditions, and to the following stipulations and conditions printed on back hereof, which are hereby specifically referred to and made a part of this policy, * * * ."

(Here appears the company's signature and countersignature of agent.)

[103] Printed on the back of said policy appeared the following:

" * * * *

"This policy shall be cancelled at any time at the request of the insured; or by the company by giving five days notice of such cancellation. If this policy shall be cancelled as hereinbefore provided, or become void or cease, the premium having been actually paid, the unearned portion shall be returned on surrender of this policy or last renewal, this company retaining the customary short rate; except that when this policy is cancelled by this company by giving notice it shall retain only the *pro rata* premium.

" * * * * "

"CALIFORNIA

"STANDARD FORM FIRE INSURANCE POLICY.

" * * * *

"The Globe & Rutgers Fire Insurance Company * * * In consideration of the stipulations herein named and of ——— Dollars premium does insure ——— for the term of ——— * * * against all loss or damage by fire, except as hereinafter provided, to an amount not exceeding ———

Dollars to the following described property while located and contained as described herein, and not elsewhere, to-wit:

(Space for Description.)

" * * *

"This policy is made and accepted subject to the foregoing stipulations and conditions and those hereinafter stated, which are hereby specifically referred to, and made part of this policy, * * * ."

(Here appears the company's signature and countersignature of agent.)

[104] Printed on the back of said policy appeared the following:

"STIPULATIONS AND CONDITIONS SPECIALLY REFERRED TO.

" * * *

"Cancellation. This policy shall be cancelled at any time at the request of the insured, in which case the company shall, upon surrender of this policy, refund the excess of paid premium above the customary short rates for the expired time. This policy may be cancelled at any time, without tender of unearned portion of premium, by the company by giving five (5) days' written notice of cancellation to the insured and to any mortgagee or other party to whom, with the written consent of the company, this policy is made payable, in which case the company shall, upon surrender of the policy or relinquishment of liability thereunder, re-

fund the excess of paid premium above the *pro rata* premium for the expired time.

" * * * * "

On outside back cover—

"OREGON

"STANDARD FIRE INSURANCE POLICY.

Body of Policy—

" * * * *

"The Globe & Rutgers Fire Insurance Company * * * In consideration of the stipulations herein named and of ——— Dollars premium does insure ——— for the term of ——— * * * against all direct loss or damage by fire, except as hereinafter provided, to an amount not exceeding ——— Dollars to the following described property while located and contained as described herein, and not elsewhere, to wit:

(Space for Description.)

[105] "This policy is made and accepted subject to the foregoing stipulations and conditions, and to the following stipulations and conditions printed on the back hereof, which are hereby specially referred to and made a part of this Policy, * * * "

(Here appears the company's signature and countersignature of agent.)

Printed on the back of said policy appeared the following:

" * * * *

"This policy shall be canceled at any time at the request of the insured; or by the company by giv-

(Testimony of W. H. Gibbons.)

ing five days notice of such cancellation. If this policy shall be canceled as hereinbefore provided, or become void or cease, the premium having been actually paid, the unearned portion shall be returned on surrender of this policy or last renewal, this company retaining the customary short rate; except that when this policy is canceled by this company by giving notice it shall retain only the *pro rata* premium.

" * * * * "

It is prayed that the original of said Exhibit 1 be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit with the record herein.

WITNESS.—(Continuing.) This paper which I have is another form of policy used in Mexico and the Philippine Islands.

[106] Thereupon the policy referred to was offered and received in evidence as Petitioner's Exhibit No. 2, was so marked, and so far as it is material here was and is as follows:

PETITIONER'S EXHIBIT No. 2.

"STOCK COMPANY.

"The Globe & Rutgers Fire Insurance Company * * *

"This policy of insurance Witnesseth, that ——— (hereinafter called the insured) having paid to the Globe and Rutgers Fire Insurance Company of New York (hereinafter called the Company) the sum of ——— ——— for such insurance as

hereinafter mentioned, of the Property hereinafter described, in the Sum or Several Sums following, viz.:—

(Space for Description.)

"The Company hereby agrees with the insured, subject to the Conditions expressed in and endorsed upon this Policy and which are to be taken as part hereof, that if the Property hereinbefore described, or any part thereof, shall be destroyed or damaged by Fire between the ——— * * * ."

(Here appears the company's signature and countersignature of agent.)

Printed on the back of said policy appeared the following:

"The Conditions Referred to in This Policy are as Follows:

" * * *

"9. The Insurance may be terminated at any time at the request of the Insured, in which case the Company will retain the customary short period rate for the time the Policy has been in force. The Insurance may also at any time be terminated at the option of the Company, on [107] "notice to that effect being given to the Insured, in which case the Company shall be liable to repay on demand a ratable proportion of the premium for the unexpired term from the date of the cancelment.

" * * * * "

It is prayed that the original of said Exhibit 2 be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit with the record herein.

Thereupon counsel for petitioner stated that the British Columbia form of policy is provided for by the Insurance Act of the Province of British Columbia, being Chapter 20 of British Columbia Statutes of 1925, as amended by Chapter 35 of said statutes for 1926–1927, and Chapter 19 of said Statutes for 1928, and was permitted to read into the Record subdivision 10 of Section 142 thereof, as follows:

"(1) Insurance may be terminated:

"(a) Subject to the provision of condition 9, by the insurer giving to the insured at any time fifteen days' notice of cancellation by registered mail or five days' notice of cancellation personally delivered, and, if the insurance is on the cash plan, refunding the excess of the premium actually paid by the insured beyond the *pro rata* premium for the expired term;

"(b) If on the cash plan by the insured giving written notice of termination to the insurer, in which case the insurer shall, upon surrender of this policy [108] refund the excess of premium actually paid by the insured beyond the customary short rate for the expired time.

"(2) Repayment of the excess premium may be made by money, post office order or postal note or by cheque payable at par and certified by a chartered bank doing business in the Province. If the notice is given by registered letter, such repayment shall accompany the notice, and in such case the fifteen days mentioned in clause (a) of this condition shall commence to run from the day

(Testimony of W. H. Gibbons.)

following the receipt of the registered letter at the post office to which it is addressed."

WITNESS.—(Continuing.) Brown & Sons wrote marine insurance. Cargo insurance is not cancellable but ceases when the voyage is finished. The premium is considered earned when the voyage begins, and after the voyage is once started the risk is attached, there is no cancellation, no return premium, and no return commission.

TESTIMONY OF ARTHUR M. BROWN, ON HIS OWN BEHALF.

ARTHUR M. BROWN, petitioner, called as a witness on his own behalf, being first duly sworn, testified, as follows:

Direct Examination by Mr. DUNNE.

My name is Arthur M. Brown. I am the petitioner. I am the senior partner of the firm of Edward Brown & Sons, general insurance agents.

[109] The difference between local agents and general agents is that a local agent is the solicitor, the man who directly gets the business, and the general agent is the one who underwrites it for the companies, an insurance wholesaler.

I first engaged in business with Edward Brown & Sons, and became a proprietary member of the organization in 1896, and have been in that business continuously since. The agency arrangements of Edward Brown & Sons were changed to provide

(Testimony of Arthur M. Brown.)

for an overriding commission about 1900. Before that time the firm had been operating on a flat commission scale of compensation out of which it paid to the local agents of the companies the commissions due them. That was changed to an arrangement whereby we were authorized to directly pay the commission to the agents, and we, instead of participating in a flat commission, were compensated by an overriding commission, over and above the commission paid to the local agents and brokers. If we were on a flat commission basis, and the rate of commission of the local agents and brokers was raised, that would cut the income down in proportion—in proportion that the increase bore to the original compensation commission. That is not true under the overriding commission plan. The company pays changes in the rates of local agents, and we receive the same scale of overriding commission.

The rate of commission for local agents is fixed by the Board of Fire Underwriters of the city, and our compensation is [110] fixed by agreement with the companies.

From 1896 to 1904, when my father died, the firm of Edward Brown & Sons consisted of my father, myself and my brother. This paper handed to me dated San Francisco, June 1, 1902, is the agreement between the partners as to the division of the earnings of the firm, subject to a payment to the three daughters of my father. Thereupon the document referred to was offered and received

in evidence as Petitioner's Exhibit No. 3, was so marked, and is as follows:

PETITIONER'S EXHIBIT No. 3.

"San Francisco, June 1st, 1902.

"Edward Brown, Arthur M. Brown and Herbert H. Brown, doing business under the firm name of EDWARD BROWN & SONS, as General Agents of Fire Insurance Companies, at 411–413 California, Street, San Francisco, in the State of California, hereby agree and declare their respective interests in such business to be as follows;

"After First setting apart and paying the sum of Two Hundred and Fifty Dollars ($250) per month as hereinafter provided for, the remaining profits to be divided as follows:

"EDWARD BROWN to have four-tenths;

"ARTHUR M. BROWN to have four-tenths;

"HERBERT H. BROWN to have two-tenths.

"Bad debts and all other losses connected with the business to be borne by the several parties in like proportions.

"Before any division of profits is made the said partners mutually agree to pay monthly to Jessie H. Jones, Edith H. Halton and Ethel Brown, (the three daughters of Edward Brown and Sisters of Arthur M. and Herbert H. Brown) [111] the sum of Two Hundred and Fifty Dollars (250) and Further, that whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand Dollars per annum they will pay a one-sixth proportion of such excess to the

(Testimony of Arthur M. Brown.)

said Jessie H. Jones, Edith H. Halton and Ethel Brown.

"They further agree that in the case of the Death of one or more members of the said firm his or their heirs or executors shall be paid annually, for a term not exceeding ten years from the date of the death of such member or members, such proportion of the net profits of said firm as hereinafter is proportion (provided),

"To the heirs or executors of EDWARD BROWN One-tenth;

"To the heirs or executors of ARTHUR M. BROWN two-tenths;

"To the heirs or executors of HERBERT H. BROWN one-tenth;

"PROVIDED that should Herbert H. Brown die before marrying no payment shall be required to be made to his heirs or executors.

"It is further agreed that monthly installments on account of the said proportionate interest or interests shall be made on demand to such heirs or executors.

"Witness our hands the date and place above mentioned.

"EDWARD BROWN.
"ARTHUR M. BROWN.
"HERBERT H. BROWN."

WITNESS.—(Continuing.) This paper handed to me and dated May 28th, 1907, was a substitution for the previously dated agreement between my two sisters, my oldest sister having died in the

(Testimony of Arthur M. Brown.)

meantime. The signatures at the foot of the instrument are the [112] signatures of my sisters, Edith Halton and Ethel Crandell. That agreement has never been modified or changed by any subsequent writing. It refers to an agreement dated in 1905. I have searched for that agreement, and have been unable to find it.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 4, was so marked, and is as follows:

PETITIONER'S EXHIBIT No. 4.

"We, Edith H. Halton and Ethel Crandell, the undersigned, and each of us, and the survivor of us, do and does hereby consent and agree to accept from the firm of Edward Brown & Sons, General Fire Insurance Agents, San Francisco, California, the sum of Two Hundred and fifty (250) dollars per month, commencing with the month beginning June 1st, 1907, and ending only by mutual agreement in full satisfaction of all amounts which may be due, or may become due, to us, or either of us, or to the survivor of us, from said firm, under and by reason of the provisions of that certain Agreement dated May 27th, 1905, by and between Arthur M. Brown and Herbert H. Brown, as surviving members of said firm and as Heirs, and as Executors of the Will, of Edward Brown, deceased; Henry Michaels, as Executor of said Will; and Jessie H. Jones, Edith H. Halton and Ethel Crandell, as Heirs, and as residuary legatees and devisees under the Will, of Edward Brown, deceased; and Irene

(Testimony of Arthur M. Brown.)

W. Brown, as widow and an Heir, and as a legatee under the Will, of Edward Brown, deceased: Provided that any further amounts to which we, or either of us, or the survivor of us, might be entitled from said firm under said Agreement shall be retained in the net profits of said firm as the property and to the credit of said Arthur M. Brown and Herbert H. Brown, members of said firm, to be divided between them as they may agree.

"Witness our hands this 28th day of May, A. D. 1907.

"EDITH H. HALTON.
"ETHEL CRANDELL.

"Witness:
"W. H. WATSON
"FREDERICK C. BROWN"

[113] WITNESS.—(Continuing.) My father died in 1904. From 1904 to 1922 the directors of the business of Edward Brown & Sons were my brother and myself. Our interests were 60% to me and 40% to my brother, and expenses were borne and profits shared in that relation, subject to this written agreement which has been introduced in evidence. After 1907 there was no change in the proprietorship of that business until my brother's death in August, 1922. After that there was no person other than myself, with the exception of my sisters, under this written agreement, who had any proprietorship in the business until, eventually, my son, Arthur M. Brown, Jr., was admitted as a partner in the business. I think

(Testimony of Arthur M. Brown.)

there was a written agreement of partnership between myself and my son, but I do not recall when it was executed. The effective date of my son's participation was January 1, 1924; and his first participation was 25%, and it was subsequently changed and he has a 40% interest.

This paper handed to me dated June 1, 1920, is the agreement of the terms of the general agency between the Svea and Edward Brown & Sons, that is my brother and myself. The endorsements attached are the recognition of myself as the general agent of the company on my brother's death, and later the recognition of my son as a partner under the same firm title of Edward Brown & Sons.

[114] Thereupon the document referred to, together with the two endorsements referred to, together with a third endorsement entitled "Amendment No. 3," was offered and received in evidence as Petitioner's Exhibit No. 5, and was so marked. Subsequently, copies of said original documents were substituted for said originals and marked Exhibit 5, and said originals and copies were and are as follows:

PETITIONER'S EXHIBIT No. 5.

[115] "This Agreement, made this First (1st) day of June, One Thousand Nine Hundred and Twenty (1920), by and between the BRAND— & LIFFORSAKRINGS AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, LIMITED, OF GOTH-

ENBURG, SWEDEN, party of the first part, and ARTHUR M. BROWN and HERBERT H. BROWN, as copartners constituting the firm of EDWARD BROWN & SONS, OF SAN FRANCISCO, CALIFORNIA, parties of the second part, Witnesseth;—

"I.

"Whereas said parties have been operating under an agreement made the First (1st) day of June, One Thousand Nine Hundred and Thirteen (1913), and it is now desired to make a new agreement, it is agreed that the said agreement of Nineteen Hundred and Thirteen (1913) shall be discontinued, except in so far as it applies to matters now pending under same.

"II.

"Party of the first part hereby continues the appointment of parties of the second part as its General Agents for the following

"TERRITORY.

"The States of

ARIZONA,
CALIFORNIA,
COLORADO,
IDAHO,
MONTANA,
NEVADA,
NEW MEXICO,
OREGON,
UTAH,
WASHINGTON,
WYOMING,

"The Territories of

ALASKA,

HAWAII and

"The Province of

BRITISH COLUMBIA,

and such other territory as may hereafter be agreed upon, with full authority to appoint and remove agents; to accept service of process for the SVEA FIRE AND LIFE INSURANCE COMPANY; to adjust and pay losses under the policies of said Company; to receive and acknowledge service of Proofs of Loss; to issue, countersign and cancel its policies and to receive and receipt for premiums thereon, and to transact such other business as usually pertains to a General Agency of a Fire Insurance Company.

[116] "Parties of the second part accept the appointment; agree to faithfully perform the duties which usually devolve upon General Agents; to use their best endeavors on behalf of said party of the first part; to promptly obey such instructions as they may, from time to time, receive and to conduct their agency in accordance with the rules and regulations of the Rating Organizations operating in said territory when not in conflict with law. Parties of the second part shall be liable for the consequences of any wilful violations made by them of instructions received by them from party of the first part.

"III.

"PAYMENT OF PREMIUMS.

"Parties of the second part guarantee the pay-

ment to the party of the first part of all premiums on policies issued by them or their agents, and shall in no case be entitled to credit by reason of their failure to collect said premiums from their agents or from the assured.

"IV.

"REINSURANCE.

"Said parties of the second part are authorized to accept lines in excess of the amounts provided for in the General Instructions of the party of the first part, provided such excess lines are immediately reinsured by parties of the second part with the Treaty Companies of the party of the first part. Should further reinsurance be necessary of amounts in excess of the aggregate amount of the retentions of the party of the first part and its Treaty Companies, such reinsurance shall also be immediately effected by parties of the second part in Companies acceptable to the party of the first part.

"On risks which are of such desirable character that the party of the first part carries at least 1.000:— net, an equal amount to the net retention of the party of the first part may be transferred to the 'Home Office Account.'

"V.

"COMPENSATION.

"Party of the first part will allow parties of the second part commencing from June First (1st) One Thousand Nine Hundred and Twenty (1920), as compensation for their services, an overriding commission of Fifteen (15%) per cent. upon such

premiums (less return and reinsurance premiums) on which the local agency [117] commission under the rules of the Pacific Board of Fire Underwriters is Fifteen (15%) per cent., and an overriding commission of Twelve and one-half (12½%) per cent. upon the premiums (less return and reinsurance premiums) of all other business.

"Party of the first part shall pay, through parties of the second part, all brokerages and commissions, Government and State taxes, licenses and fees and assessments for the maintenance of Rating Associations and Fire Patrols.

"Party of the first part hereby agrees to pay the parties of the second part the amounts of contingent commissions actually allowed the local agents representing the party of the first part in the Territory of Hawaii, the Province of British Columbia and the General and Farm Agents for the State of Colorado.

"Parties of the second part shall also be allowed to charge all actual expenses (according to vouchers to be rendered with the monthly statements) for policy, daily report, endorsement and other blanks necessary to the reporting of the business to the party of the first part; for office and outside signs furnished by the parties of the second part to their sub-agents or brokers; for advertising blotters and for disbursements for postal and telegraph expenses in direct service to the party of the first part or its United States Manager at New York.

"Parties of the second part shall not be entitled to charge the party of the first part for any other expenses, save that it is understood and agreed that the parties of the second part shall also be allowed all actual expenses of litigation incurred on behalf of the party of the first part in connection with any business done by the said parties of the second part under this agreement, and also all actual expenses incurred in adjustment, investigation and settlement of losses, including the guarding and handling of damaged property and effecting salvages, on business done by the parties of the second part under this agreement, according to vouchers which are to be kept on file by parties of the second part and held at the disposal of the party of the first part.

"The overriding commissions set forth are to be based upon the net lines set forth in the General Instructions of June Eighth (8th) One Thousand Nine Hundred and Twelve (1912) and are also to apply to lines transferred to the 'Home Office Account.'

"It is understood and agreed that on the business ceded to the Treaty Companies the parties of the second part shall be allowed an overriding commission of Seven and one-half (7½%) per cent. on the Fifteen (15%) per cent. business and Five (5%) per cent. on all other business, or, in other words, 7½% less overriding [118] commission than allowed on the business actually retained for own account and transferred to the 'Home Office Account' of the party of the first part.

"It is further understood and agreed that on the business hitherto transferred to the 'Special Account' the parties of the second part shall be allowed 5% less overriding commission than on the business retained for own account and transferred to the 'Home Office Account' of the party of the first part.

"VI.

"CONTINGENT COMMISSION.

"Party of the first part further agrees to pay the parties of the second part a further compensation of Fifteen (15%) per cent. contingent commission on the net profits of the General Business and the 'Home Office Account,' the net profit to be calculated as follows:

"As INCOME:

"1. Premium reserve from previous year.

"2. Losses unsettled and pending from preceding years with deduction of reinsurance and 'Special Account' proportions.

"3. Amounts of premiums written during the year, with deduction for return premiums and reinsurance as well as 'Special Account' premiums.

"As EXPENDITURE:

"1. Commission and all expenses allowed under this agreement, with deduction of an amount equal to 25% on the net business ceded to the Treaty Companies and 32½% on the net business transferred to the 'Special Account.'

"2. Such proportion of expenses in connection with the United States Trustees of the party of the first part and financial transactions with the named United States Trustees through the New York Department of the party of the first part as the yearly premium income from the General Agency of the parties of the second part bears toward the premium income of the entire United States business of the party of the first part.

"3. All losses paid during the year, with deductions for reinsurance and 'Special Account' proportions.

[119] "4. All outstanding and unpaid losses at the end of the fiscal year, with deduction for reinsurance and 'Special Account' proportions.

"5. Forty (40%) per cent. premium reserve on the net premiums written during the year, with deduction for return premiums and reinsurance as well as 'Special Account' premiums.

"Should there be a net loss instead of a net profit shown by any such statement the amount of such loss shall not be charged in any subsequent statement in ascertaining the net profit for any subsequent period.

"VII.

"RATE WAR.

"In case of a general reduction in rates to such

a figure that party of the first part is unwilling to accept the business offered and its policies are surrendered by the assured, it is agreed that the earned premiums will be computed at short rates, that parties of the second part will as far as possible require agents and brokers to charge back return commissions, and party of the first part will allow return commissions to be charged to it on same basis as is allowed to agents and brokers by parties of the second part. The parties of the second part will not be required to refund their overriding commission on policies thus cancelled.

"VIII.

"BOND.

"The parties of the second part shall furnish to the party of the first part a bond of the Fidelity & Casualty Co., of New York, in the sum of Twenty Thousand Dollars ($20,000.) for their faithful performance of this agreement and for payment to the party of the first part of all amounts due from parties of the second part to the party of the first part.

"IX.

"TERMINATION OF CONTRACT.

"This agreement shall govern all business done by the parties of the second part hereunder, unless changed by mutual agreement of the parties hereto, but this agreement may be terminated at any time by either party giving the other ninety (90) days' notice in writing or by cablegram, at the expira-

tion of which time this contract shall cease and determine.

[120] "In case the party of the first part should desire to withdraw from or terminate its business in any of the States and/or Territories embraced in this agreement it may do so by giving ninety (90) days' notice in writing or by cablegram to the parties of the second part, who shall under such notice, provided the party of the first part so instructs the parties of the second part, reinsure such business in a company satisfactory to the party of the first part or cancel same. In case the party of the first part so desires, such business may remain on the books and be allowed to run off to expiration.

"The party of the first part shall bear the expenses which are necessary to effect the termination of the business in question, i. e. traveling expenses of Special Agents in closing local agencies, as well as telegrams and postage in connection therewith. In case of cancellation of the business as above set forth, the parties of the second part shall not be responsible for return commissions, except such portions as are collected from local agents on canceled policies belonging to the business in question. In case the business is reinsured, the whole commission obtained from the reinsuring company belongs to the party of the first part, and in computing the contingent, if any, due the parties of the second part for the year of such withdrawal, the gross reinsurance premiums, or the gross return premiums occa-

sioned by such withdrawal are to be charged against the parties of the second part.

"IN WITNESS WHEREOF, the said party of the first part has caused these presents to be executed in duplicate by its President and one member of The Board and its Corporate Seal to be hereunto affixed, and the parties of the second part have hereunto attached their firm name and affixed Seal.

"Gothenburg, May 17th, 1920.

"BRAND:- OCH LIFFORSAKRINGS—
AKTIEBOLAGET SVEA,
"CARL KINDAL,
"THEODOR HYKANDS.

[121] "AMENDMENT No. 3

to the Contract, made the first (1st) day of June, One Thousand Nine Hundred and Twenty (1920), by and between the BRAND— & LIFFORSAKRINGS-AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, LIMITED, of Gothenburg, Sweden, party of the first part, and ARTHUR M. BROWN and ARTHUR M. BROWN, Jr., as copartners constituting the firm of EDWARD BROWN & SONS, of San Francisco, California, parties of the second part.

"IT IS HEREBY UNDERSTOOD AND AGREED that the following changes of the above-mentioned contract are made to take effect as of January first (1st), One Thousand Nine Hundred and Twenty Six (1926), viz:

"ARTICLE V.

"COMPENSATION.

"Paragraph seven (7) of this Article is changed to read:

"'It is understood and agreed that on business ceded to the Treaty Companies the parties of the second part shall be allowed an overriding commission of Nine and one-half (9½%) per cent. on the fifteen (15%) per cent. business and Seven (7%) per cent. on all other business or, in other words, 5½% less overriding commission than allowed on the business actually retained for own account and transferred to the "Home Office Account" of the party of the first part.'

"Paragraph eight (8) is hereby revoked on account of the discontinuance of the 'Special Account.'

"ARTICLE VI.

"CONTINGENT COMMISSION

"All prescriptions in this Article bearing upon the 'Special Account' are hereby revoked, following the discontinuance of the 'Special Account.'

"IN WITNESS WHEREOF, the said party of the first part has caused these presents to be executed in duplicate by its President and one member of the Board and its Corporate Seal to be hereunto

affixed, and the parties of the second part have hereunto attached their firm name and affixed Seal.

"Gothenburg, April 22, 1926.

"BRAND— & LIFFORSAKRINGS AK-TIEBOLAGET SVEA,

(Seal) "CORNELIUS PINEUS.

"THEODORE HYKANDS.

[122] "AMENDMENT

to the Contract, made the first (1st) day of June, One Thousand Nine Hundred and Twenty (1920), by and between the BRAND— & LIFFORSAK-RINGS AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, LIMITED, of Gothenburg, Sweden, party of the first part, and ARTHUR M. BROWN and HERBERT H. BROWN, as copartners constituting the firm of EDWARD BROWN & SONS, of San Francisco, California, parties of the second part.

"I.

"IT IS HEREBY AGREED that the named contract from January first (1st), One Thousand Nine Hundred and Twenty-three (1923), shall be constituted as made by and between the BRAND— & LIFFORSAKRINGS AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, of Gothenburg, Sweden, party of the first part, and ARTHUR M. BROWN, Sr., and ARTHUR M. BROWN, Jr., doing business under the firm name of EDWARD

BROWN AND SONS, of San Francisco, California, parties of the second part.

"IN WITNESS WHEREOF, the said party of the first part has caused these presents to be executed in duplicate by its President and one member of the Board and its Corporate Seal to be hereunto affixed, and the parties of the second part have hereunto attached their firm name and affixed seal.

"Dated, August 30th, 1923.

"CARL KINDAL.

"THEODOR HYKANDS.

[Seal] "ARTHUR M. BROWN,

Of and for Edward Brown Sons.

[123] "AMENDMENT

to the Contract, made the first (1st) day of June, One Thousand Nine Hundred and Twenty (1920), by and between the BRAND— & LIFFORSAKRINGS AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, LIMITED, OF GOTHENBURG, SWEDEN, party of the first part, and ARTHUR M. BROWN and HERBERT H. BROWN, as copartners constituting the firm of EDWARD BROWN & SONS, OF SAN FRANCISCO, CALIFORNIA, parties of the second part.

"I.

"IT IS HEREBY AGREED that the named contract from August First (1st), One Thousand

(Testimony of Arthur M. Brown.)

Nine Hundred and Twenty two (1922), shall be considered as made by and between the BRAND— & LIFFORSAKRINGS AKTIEBOLAGET SVEA, also known as the SVEA FIRE AND LIFE INSURANCE COMPANY, OF GOTHENBURG, SWEDEN, party of the first part, and ARTHUR M. BROWN, doing business under the firm of EDWARD BROWN AND SONS, OF SAN FRANCISCO, CALIFORNIA, party of the second part.

"IN WITNESS WHEREOF, the said party of the first part has caused these presents to be executed in duplicate by its President and one member of the Board and its Corporate Seal to be hereunto affixed, and the party of the second part has hereunto attached his firm name and affixed Seal.

"Gothenburg, September 12:th 1922

"BRAND— OCH LIFFORSAKRINGS-AKTIEBOLAGET SVEA.

[Seal] "A. W. HITMAN.

"THEODOR HYKANDS."

[124] WITNESS.—(Continuing.) This paper writing now shown to me dated January, 1911, purporting to be between the Agricultural Insurance Company of Watertown, New York, and Arthur M. Brown and Herbert H. Brown, is the general agency agreement between the Agricultural Insurance Company and our firm, and the endorsements respectively recognize me as the sole member of the firm of Edward Brown & Sons, and my son as my partner in that firm.

(Testimony of Arthur M. Brown.)

Thereupon the documents referred to were offered and received in evidence as Petitioner's Exhibit No. 6, and were so marked. Subsequently, copies of said original documents were substituted for said originals and marked Exhibit 6, and said originals and copies were and are as follows:

PETITIONER'S EXHIBIT No. 6.

[125] "THIS AGREEMENT made this first day of January, 1911, between the AGRICULTURAL INSURANCE COMPANY of Watertown, New York, party of the first part, and ARTHUR M. BROWN and HERBERT H. BROWN, constituting the firm of EDWARD BROWN & SONS of San Francisco, California, parties of the second part,

"WITNESSETH:

"FIRST—Whereas said parties have been operating under an agreement made August 11, 1897, and it is now desired to make a new agreement, it is agreed that said agreement of 1897 shall be discontinued, except in so far as it applies to matters now pending under same.

"TERRITORY.

"SECOND—Party of the first part hereby continues the apointment of parties of the second part as its General Agents for the following territory:

"Arizona
"California
"Washington
"Montana

"Idaho
"Oregon
"Nevada
"New Mexico
"Hawaii
"British Columbia

"and such other territory as may hereafter be agreed upon, with authority to appoint and remove agents, to issue and cancel policies, to collect premiums, to adjust and pay losses and to transact such other business as usually pertains to a General Agency of a Fire Insurance Company.

"Parties of the second part accept the appointment and agree faithfully to perform the duties which usually devolve upon General Agents; to use their best endeavors in behalf of said party of the first part; to promptly obey such instructions as they may, from time to time, receive and to conduct their agency in accordance with the rules and regulations of the rating organizations operating in said territory when not in conflict with law.

[126] "BOND.

"THIRD—Parties of the second part agree to furnish a BOND in the sum of Twelve Thousand Dollars ($12,000), with sureties satisfactory to the party of the first part, for the faithful performance of their duties and for the payment to the party of the first part of all amounts due from them to the party of the first part.

"REPORTS.

"FOURTH—Parties of the second part shall for-

ward to party of the first part, weekly, Daily Reports of all policies issued by them or their agents, and copies of all endorsements.

"They will also forward, not later than the tenth of each month, Monthly Reports or Statements of Account, which shall include all premiums written by them or their sub-agents during the preceding calendar month, except that the business for December in each year shall be closed on or before the 20th of that month and the Monthly Report for that month shall be forwarded not later than the 25th of December.

"PAYMENT OF BALANCES.

"FIFTH—Parties of the second part agree to pay balances due party of the first part as follows: The balance for January during the month of April; the balance for February during the month of May, and so on throughout the year. For this purpose party of the first part will treat vouchers for losses and adjustment expenses paid as a satisfactory remittance on account; and it is agreed that said remittances or vouchers will be forwarded so as to reach party of the first part before the close of the month in which they are due.

"Parties of the second part guarantee the payment to the party of the first part of all premiums on policies issued by them or their agents, and shall in no case be entitled to credit by reason of their failure to collect said premiums from their agents or from the assured, except that policies returned for non-payment of premiums within sixty

days of issue will be credited for the full premium thereon, less the commission allowed.

"RE-INSURANCE,

"SIXTH—Said parties of the second part are authorized to accept lines in excess of the amounts provided for in the line sheets of party of the first part, provided such excess [127] lines are immediately reinsured by parties of the second part in Companies acceptable to party of the first part. If such reinsurance is effected in the First Bulgarian Insurance Company in accordance with the re-insurance treaty existing between said party of the first part and said First Bulgarian Insurance Company, said parties of the second part authorize party of the first part to charge back such a percentage of the premiums ceded to the First Bulgarian Insurance Company as will make net commission cost of said reinsured lines to the party of the first part not to exceed 22½%. The said charge will be made monthly by party of the first part and reported to parties of the second part.

"COMPENSATION.

"SEVENTH—Party of the first part will allow parties of the second part, as compensation for their services, an overriding commission of 15% upon such premiums (less return and reinsurance premiums) as parties of the second part allow not to exceed 15% upon to sub-agents or brokers; and 10% upon such premiums (less return and reinsurance premiums) as under the rules of the vari-

ous rating associations parties of the second part pay more than 15% upon.

"Party of the first part shall pay through parties of the second part all brokerages and commissions, Government taxes, licenses and fees, assessments for the maintenance of rating associations and fire patrols, the actual cost of the adjustment of losses, bills for which shall accompany proofs, and shall furnish policies and Daily Report blanks and such other supplies as are usual and necessary.

"Parties of the second part shall pay all other expenses incident to the business not herein specifically assumed by party of the first part.

"CONTINGENT COMMISSION.

"EIGHTH—In addition to the compensation heretofore specified party of the first part will allow parties of the second part annually, in January, a contingent commission upon the profits of the party of the first part in said General Agency to be computed as follows:

"1. Of the premiums, less return premiums and reinsurance (both agency and home office) written during the year for party of the first part by parties of the second part, one-third shall be considered unearned and two-thirds shall be considered earned. To the earned premiums shall be added the [128] amount deducted from the previous year's computation of contingent as unearned. From this sum shall be deducted all brokerages, commissions, taxes, assessments and expenses of every name and nature borne by party

of the first part and all losses incurred (less salvage and reinsurance recovered) during the year. The balance shall be called the net profits.

"2. A sum equal to 15% of the net profits as shown in the foregoing computation shall be allowed parties of the second part by party of the first part as contingent commission.

"3. If the General Agency shall be closed at any time the settlement of the contingent commission shall be deferred until January first next following the date of termination. At that time no sum shall be deducted as unearned and no subsequent or further claim shall be made by parties of the second part on account of contingent commission.

"RETURN COMMISSIONS.

"NINTH—In case of a general reduction of rates to such a figure that party of the first part is unwilling to accept the business offered and its policies are surrendered by the assured, it is agreed that the earned premiums will be computed at short rates, that parties of the second part will as far as possible require agents and brokers to charge back return premiums to be charged to it on the same basis as is allowed to agents and brokers by parties of the second part. Parties of the second part will not be required to refund their over-riding commission.

"TENTH—This contract may be terminated at any time by either party giving the other sixty days' notice in writing, at the expiration of which time this contract shall cease and determine. It is,

however, understood and agreed that parties of the second part shall, upon request of this Company, immediately discontinue writing any policies for this Company or committing it on any risks either directly or indirectly.

"IN WITNESS WHEREOF the party of the first part has caused its corporate seal to be hereto affixed and these presents to be signed by its President, and the parties of the second part have hereunto set their hands and seals the day and year first above written.

"AGRICULTURAL INSURANCE CO.
"By W. H. STEVENS, Pdt.
"EDWARD BROWN & SONS.

[129] AGRICULTURAL INSURANCE COMPANY.

"Watertown, N. Y.
"July
Twentieth,
1923.

"Mr. Arthur M. Brown,
c/o Edward Brown & Sons,
"San Francisco, Calif.

"Dear Mr. Brown:—

"We have your letter of July 9th advising that you have taken your son, Arthur M. Brown, Jr., into partnership and ask that we authorize you to add his name to the endorsement dated August 1st, 1922, to the present agency contract. We think that the date should be referred to as August 30th, 1922. This is consented to by us and you may

use this letter in conjunction with your own as constituting the change.

"We have no doubt that the entry of your son officially into the business marks in your own mind a milestone that will always be looked upon with gratification. We wish the new organization an abundant success.

"Yours very truly,
"P. H. WILLMOTT,
"Secretary."

"PHW/P."

[130] "WHEREAS by mutual consent, and the death of Herbert H. Brown, the contract between the AGRICULTURAL INSURANCE COMPANY and ARTHUR M. BROWN and HERBERT H. BROWN, dated January 1, 1911, together with the various amendments thereto relating, *inter alia,* to additional territory and classes of business, Re-Insurance, etc., is hereby amended as follows, except so far as it applies to matters now pending under same.

"NOW, THEREFORE the AGRICULTURAL INSURANCE COMPANY hereby appoints said ARTHUR M. BROWN, trading as EDWARD BROWN & SONS, General Agent for the territory and classes therein mentioned, said appointment being subject to all the conditions named in said contract of January 1, 1911, and its amendments, and said Arthur M. Brown hereby accepts said appointment.

"Executed at Watertown, New York, this Thir-

(Testimony of Arthur M. Brown.)

tieth day of August, A. D., Nineteen hundred and twenty-two.

"AGRICULTURAL INSURANCE COMPANY,

"By W. H. STEVENS,

"President.

"ARTHUR M. BROWN.

"and at San Francisco, Calif., this 5th day of September, A. D. 1922."

[131] WITNESS.—(Continuing.)

This paper writing, dated October 11th, 1918, between Hudson Insurance Company and Arthur M. Brown and Herbert H. Brown is the general agency agreement between the Hudson Insurance Company and Edward Brown & Sons. The attached endorsements are of the same nature as the endorsements I have previously referred to.

Thereupon the documents referred to were offered and received in evidence as Petitioner's Exhibit No. 7, and were so marked. Subsequently, copies of said original documents were substituted for said originals and marked Exhibit 7, and said originals and copies were and are as follows:

PETITIONER'S EXHIBIT No. 7.

[132] "THIS AGREEMENT made and entered into this 11th day of October, 1918, by and between the HUDSON INSURANCE COMPANY, of NEW YORK, party of the first part, and ARTHUR M. BROWN and HERBERT H. BROWN, as copartners constituting the firm of

EDWARD BROWN & SONS, of SAN FRANCISCO, CALIFORNIA, parties of the second part, WITNESSETH:—

"ARTICLE I.

"In consideration of the fulfillment of the mutual agreements herein made, the party of the first part appoints the party of the second part its GENERAL AGENTS for the States of Arizona, California, Coloraro, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington and Wyoming, as well as for the territories of Alaska and Hawaii and the Province of British Columbia, with full power and authority to appoint and remove Agents in said States to accept service of process for the HUDSON INSURANCE COMPANY, to adjust losses under the policies of said Company, to receive and acknowledge service of Proof of Loss, to issue, countersign and cancel its policies and to receive and receipt for premiums thereon and generally to conduct the business of said Company in the territory above mentioned in accordance with such instructions and directions as they may from time to time receive from the said Company.

"ARTICLE II.

"The Local Agents in the said territory shall report their business to the said General Agents, and the party of the second part hereby agrees to forward promptly to the Home Office of the party of the first part, bordereaux of risks written and of endorsements made under policies issued by agents in said territory, also to promptly report in the

same manner all policies written in the office of the party of the second part and endorsements made on such policies by them; also to report promptly to the party of the first part all appointments, removals and changes of agents, and to furnish other information which said party of the first part may desire in connection with said business. The party of the first part reserves the right to reject and cancel any business sent in that is not entirely satisfactory to it.

"ARTICLE III.

"The said party of the second part shall forward not later than the Fifteenth (15th) of each month a monthly report or statement of account for the preceding month, of all [133] business done for the party of the first part by said party of the second part, as well as through all the authorized agents in the territory named, and shall forward to said party of the first part the balances shown by such statements within eighty-five (85) days after the close of the month for which said account was made up, and the said party of the second part does hereby agree to assume and does assume the responsibility to said party of the first part for the premiums written by them or by the agents in said territory. It is agreed that policies cancelled for non-payment of premiums are to be returned to the party of the first part as uncollectible within Ninety (90) days after the month in which they are issued, otherwise the said party of the first part is to be credited with the earned premium for the full period from the date of issue to the date of

cancellation. It is understood that on all cancellations and reinsurance effected on business written under this Agreement there shall be returned to the said Company the same percentage of commission, inclusive of overriding commission, as was allowed on the original transaction.

"ARTICLE IV.

"The said party of the second part shall forward to said party of the first part a satisfactory Bond in the sum of Ten Thousand ($10,000) Dollars conditioned upon the satisfactory discharge of their indebtedness to the said party of the first part and the faithful performance of their obligations under this Contract.

"ARTICLE V.

"The party of the second part shall forward to the party of the first part weekly reports of all losses, and the party of the second part is hereby authorized to provide for the adjustment of the losses, the losses when adjusted to be paid in the manner directed by the party of the first part. It is, however, understood and agreed that in event of differences arising in the adjustment of any loss, or in case of threatened litigation arising in connection with any claim, the party of the second part will immediately and fully communicate all the facts to the party of the first part, so that the party of the first part may have full information and advise the party of the second part of its wishes in the matter.

"ARTICLE VI.

"Said party of the first part agrees to pay the

party of the second part an overriding commission of Fifteen (15%) per cent on the net premiums written in cases where the local agency commission under the rules of the Pacific Board [134] of Fire Underwriters is Fifteen (15%) per cent., and an overriding commission of Twelve and one-half (12½) per cent. on all other business. By net premiums is meant gross premiums less return premiums and reinsurance placed through the said General Agents.

"The party of the first part hereby agrees to pay the party of the second part the amount of contingent commission actually allowed the local agents representing the party of the first part in the territory of Hawaii and the Province of British Columbia.

"The said overriding commission of Fifteen (15%) per cent. and twelve and one-half (12½) per cent., respectively, shall be in full for all costs of the business of the party of the first part, with the exception of commissions paid to local agents, taxes, fees, licenses (both State and Municipal) loss adjustment expenses paid by the party of the second part, legal expenses, advertising required by Law, Local Board and Fire Patrol assessments; and the party of the first part further agrees to furnish for the use of the agents in said territory policy blanks, daily report and endorsement blanks, as well as other supplies which are necessary for the reporting of the business to the party of the first part, together with such signs, blotters, and

other advertising matter as said party of the first part may see fit to furnish.

"ARTICLE VII.

"IT IS UNDERSTOOD AND AGREED that on the business ceded to the Treaty Companies the party of the second part shall be allowed an overriding commission of seven and one-half (7½) per cent. on the Fifteen per cent. (15%) business, and Five per cent (5%) on all other business, or, in other words, 7½% less overriding commission than allowed on the business actually retained for own account by party of the first part.

"ARTICLE VIII.

"IT IS UNDERSTOOD AND AGREED that the party of the second part may issue policies against the hazard of explosion and may also write hail insurance, the commission on said business to be (inclusive of overriding commission) Twenty (20%) per cent. and Thirty-two and one-half (32½%) per cent. respectively, with 7½% deduction for portions reinsured, as above set forth.

"ARTICLE IX.

"THE PARTY OF THE FIRST PART FURTHER AGREES to pay the party of the second part a further compensation of fifteen [135] per cent. (15%) contingent commission on the net profits earned on the business transacted for the party of the first part, the net profits to be determined by calculations as follows:

"INCOME

"(1) Gross premiums written during the year, with deduction for return premiums and reinsurance premiums.

"(2) Premium Reserve from Statement of the previous year.

"(3) Losses unpaid from the statement of the previous year, with deductions for reinsurance proportions.

"OUTGO

"(1) Commissions and all expenses of every nature allowed under this Agreement, with deduction of an amount equal to 25% on the net business ceded to the Treaty Companies.

"(2) All losses paid during the year with deduction for reinsurance proportions.

"(3) All unpaid losses at the end of the fiscal year, with deduction for reinsurance proportions.

"(4) Forty per cent (40%) Premium Reserve on the net premiums written during the year, with deduction for return premiums and reinsurance premiums, as well as Hail premiums.

"IT IS UNDERSTOOD AND AGREED that the first calculation of profit under this Contract shall be made up as of December 31, 1919, and forwarded to the party of the second part as soon as possible after the date referred to, and annually thereafter, on the business of each single fiscal year, as long as this Agreement shall remain in

force. PROVIDED, HOWEVER, that [136] should this Contract be terminated before the close of any fiscal year, the contingent commission shall nevertheless be computed for the whole fiscal year as above set forth.

"ARTICLE X.

"In case of a general reduction in rates, to such a figure that the party of the first part is unwilling to accept the business offered, and its policies are surrendered by the assured, it is UNDERSTOOD AND AGREED that the earned premiums will be computed on the short rate basis, and that the party of the second part will endeavor as far as possible to obtain from the Agents and Brokers the return commissions due the party of the first part, but failing so to do the party of the first part waives the right of charging the party of the second part with such uncollectible amounts, and it is FURTHER UNDERSTOOD AND AGREED that the parties of the second part will not be required to refund their overriding commission on policies thus cancelled.

"ARTICLE XI.

"This Contract may be terminated at any time by either party giving Ninety (90) days notice to the other, at the expiration of which time this Contract shall cease and terminate, and in case of their so doing neither shall have any claim on the other for loss of prospective profit or damage to business arising therefrom, and the duties of each party to the other shall continue in full force and effect

until the termination of said Ninety (90) days, unless otherwise mutually agreed.

"IN WITNESS WHEREOF, the said HUDSON INSURANCE COMPANY of NEW YORK, and EDWARD BROWN & SONS, of SAN FRANCISCO, CALIFORIA, have affixed their signatures to this AGREEMENT the day and year first above written.

"HUDSON INSURANCE COMPANY,

"(Corporate Seal)

"J. W. WENNSTROM,

"Vice-President.

"EDWARD BROWN & SONS,

"HERBERT H. BROWN.

"C. N. MORGAN,

"Secretary.

"FRANK G. CLARK.

[137] "ADDENDUM to AGREEMENT made and entered into October 11th, 1918, by and between the Hudson Insurance Company, of New York, party of the first part, and, in accordance with duly executed Addendum, Arthur M. Brown and Arthur M. Brown, Jr., of San Francisco, Calif., as copartners constituting the firm of Edward Brown & Sons, parties of the second part.

"WITNESSETH: IT IS HEREBY MUTUALLY UNDERSTOOD AND AGREED that from January 1st, 1926, the present wording of Article VII is hereby deleted and shall read as follows:

"ARTICLE VII.

"'It is understood and agreed that on the busi-

ness ceded to the Treaty Companies the party of the second part shall be allowed an overriding commission of Nine and one-half (9½) per cent on the fifteen (15) per cent business and seven (7) per cent on all other business. Or, in other words, five and one-half (5½) per cent less overriding commission than allowed on the business actually retained for own account by the party of the first part.'

"It is further understood and agreed that from the date mentioned, in Article IX, Outgo (1) Thirty (30) per cent is substituted for twenty-five (25) per cent.

"Made in duplicate, duly signed and executed in New York, this 8th day of April, 1926.

"HUDSON INSURANCE COMPANY,

"(Corporate Seal)

"By J. M. WENNSTROM,

"President.

"and in San Francisco, on the 26th day of April, 1926.

"EDWARD BROWN & SONS, General Agents.

"By ARTHUR M. BROWN, Jr.

[138] "ADDENDUM TO AGREEMENT

"made and entered into October 11th, 1918, by and between The Hudson Insurance Company, of New York, party of the first part, and Arthur M. Brown and Herbert H. Brown, of San Francisco, California, constituting the firm of EDWARD BROWN & SONS, party of the second part,

"WITNESSETH:

"IT IS HEREBY UNDERSTOOD AND

AGREED that the firm of Edward Brown & Sons, party of the second part, is now constituted of Arthur M. Brown and Arthur M. Brown, Jr., as co-partners.

"Made in duplicate and duly signed and executed in New York, July 27th, 1923.

"HUDSON INSURANCE CO.

"(Corporate Seal)

"J. M. WENNSTROM,

"President.

"and in San Francisco, California, August ——, 1923.

"EDWARD BROWN & SONS,

_____.

_____.

[139] (LETTER-HEAD OF HUDSON INSURANCE COMPANY OF NEW YORK.)

"AMENDMENT TO AGREEMENT DATED OCTOBER 11th, 1918, BETWEEN HUDSON INSURANCE COMPANY OF NEW YORK AND EDWARD BROWN & SONS, GENERAL AGENTS, OF SAN FRANCISCO, CAL.

"This contract is hereby changed to read:

"HUDSON INSURANCE COMPANY OF NEW YORK AND ARTHUR M. BROWN, DOING BUSINESS AS EDWARD BROWN & SONS.

_____,

"Vice President.

"August 1st, 1922."

(Testimony of Arthur M. Brown.)

[140] WITNESS.—(Continuing.) During the years in question, from 1918 on, we were also Pacific Coast general agents for the United States Merchants and Shippers Insurance Company, sometimes known as United States Lloyds, appointed under a written contract. I have had search made for that contract but have been unable to find it. It was kept in our vault at our office at #200 Bush Street, and I caused search to be made in that vault, but was unable to find it. It was in all respects like the Agricultural Insurance Company contract. I drafted it by copying the Agricultural contract.

During this period Edward Brown & Sons also represented the Hamilton Fire Insurance Company and was Pacific Coast general agent for Globe & Rutgers Fire Insurance Company of New York City, but we did not have a written contract with either. "Globe Underwriters" is not an independent corporation, but simply a title under which Globe & Rutgers Fire Insurance Company is permitted to operate. In the conduct of the business for the Hamilton Fire Insurance Company and the Globe & Rutgers Fire Insurance Company for 1917 and on through 1926 the business was not conducted in any different way, nor did we do any different things for those companies than for the companies as to which written contracts have been introduced in evidence. The business as to all of [141] the companies was conducted exactly the same. There were differences in rates of commission. The rate

(Testimony of Arthur M. Brown.)

of commission for the Hamilton was 11% overriding commission paid on the basis of net premiums. Net premiums are the gross premiums written, less cancellations and reinsurance as effected. For the Globe & Rutgers we received 11% overriding commission on certain of the business, known as our direct writings, and 7% overriding commission on what was known as the surplus amount, and 2½% on other business. These commissions were on policies which our office wrote and which were written through our territory. Our commissions for the Globe & Rutgers were figured on a net premium basis. That was arrived at in exactly the same way as outlined in the contracts here. It was agreed upon in conversations between ourselves and officers of the company. All compensations were upon net premium writings. The substance of the conversations with respect to our duties were that we were to appoint and cancel agencies, supervise underwriting, attend to all endorsements and cancellations as they came in, collect and remit to the companies premiums due net to them, adjust and pay all losses, represent the company, and attend to any legal matters that might come up in connection with the business and to attend to all the affairs of the company within the territory in which we operate. For the Globe & Rutgers Fire Insurance Company we operate the entire Pacific Coast, ten states, the territories of Alaska and Hawaii and the Philippine Islands. For

(Testimony of Arthur M. Brown.)

the Hamilton we operate the States of California, Oregon and Washington.

[142] In nearly every case a policy is written by the agent. We have no direct dealings with the assured.

Thereupon counsel for petitioner read into the record Section 5009 of the Compiled Statutes of the State of Idaho as follows:

> "It shall be unlawful for any foreign insurance company doing business in this State to make, write, place or cause to be made, written or placed in this State, any policy, bond, duplicate policy, or contract of insurance of any kind or character or of any general or floating policy upon persons or property resident, situated or located in this State, unless done through an agent who is a resident of this State and licensed to transact insurance business herein. A resident agent shall countersign all policies issued (except policies of life insurance), and shall receive the full commission when the premium is paid, to the end that the State may receive the tax required by law to be paid on the premiums collected for insurance on all persons and property resident or located within this State: Provided this section shall not apply to life insurance companies."

WITNESS.—(Continuing.) No different procedure was followed with respect to the commission of the local agents in any territory for any of our companies than was followed with respect to the com-

(Testimony of Arthur M. Brown.)

mission of the local agent in the State of Idaho—they were all treated the same in the territories.

When we were appointed general agent for a company we performed service for the company before the actual writing of any insurance. Agents had to be appointed and all the State papers had to be attended to, to obtain the company's entry into the state. We handled the details of the qualification of a company [143] to do business in the state as a foreign corporation, and the details with respect to the offices of the insurance commissions of the various states. We have to see that the company is put into condition to do business in a particular state. With the exception of policy blanks and reports of the company we furnish all of the stationery for the writing of insurance. The agents are, in a great majority of cases, appointed by special agents employed by us, fieldmen, we call them. This is the certificate we use for agents (producing document).

Thereupon the document produced was offered and received in evidence as Petitioner's Exhibit No. 8, was so marked, and was and is as follows:

PETITIONER'S EXHIBIT No. 8.

"This is an Agency of

"EDWARD BROWN & SONS

"Pioneers of Protection

"Since 1875

"CERTIFICATE OF AUTHORITY.

"BE IT KNOWN, that ——— of ———, in the county of ——— in the State of ———,

(Testimony of Arthur M. Brown.)

ha—— been appointed by these presents duly constituted agent of the following, to wit: ——— with full power to receive proposals for insurance against loss or damage by fire, in ——— and vicinity, to ——— deliver policies to applicants, and collect and forward the premiums on same, subject to the rules and instructions which may, from time to time, be given by the General Agents of the said Company.

[144] "IN WITNESS WHEREOF, the General Agents of the ——— Insurance Company have signed these presents in the City of San Francisco, California, this —— day of ———, 19——.

"———————————

"Pacific Coast General Agents."

WITNESS.—(Continuing.) Edward Brown & Sons had full authority to select and employ agents and to revoke their licenses when deemed necessary, and during this whole period that practice was actually followed. The agent or broker is the one who actually goes out, gets the assured, and sells him the contract of insurance. We have nothing to do with that. We prepare the necessary stationery forms and supply these to the local agents, and we supply them with a great deal of servicing and information service. We employ fieldmen whose business it is not only to appoint agents but to assist them in obtaining business, at their request to survey and assist them in rating risks, and to do everything they can to push the agent's business. That service has no relation to the writing of any par-

(Testimony of Arthur M. Brown.)

ticular policy, and such service has, in fact, been given, when the policy was written in some company not represented by us.

As to the actual writing of the policy there are two classes of agents; recording agents and nonrecording agents. The former are the larger ones who have a thorough knowledge of the [145] business and are permitted to sign policies. Those who are doing a small business and are not equipped send their applications to our office and the policies are written there. In the greater number of instances these policies are sent back to the agent to be countersigned. There is no difference in the rate of commission paid to recording and nonrecording local agents, nor is there any difference in the rate of commission we receive on policies written by recording or nonrecording agents.

We must perform service in connection with determining what form of policy shall be used on a particular risk. We supply the recording agents with a full set of forms. The nonrecording agents' applications are certified in our office, and the form there determined. Riders are used in writing insurance. We supervise the supplying of riders and when they are used we must scrutinize them as carefully as the original policy. The form of riders is determined by the Board of Underwriters of the Pacific. We perform a service in connection with that organization. I am chairman of what is known as the Standard Forms Bureau, which is a subsidiary body of the Underwriters of the Pacific,

(Testimony of Arthur M. Brown.)

and for many years have been on many of the committees.

The Board of Underwriters of the Pacific is an organization made up of the great majority of the standard insurance companies, for the survey and betterment of business and the making of [146] rates. We act on the Board of Underwriters for the companies for whom we are general agent.

When an agent sends us a policy which has been written we have to inspect the risk, and it is entirely up to us whether that risk shall be accepted or rejected. That matter is not referred to the home office, and we have rejected many risks submitted by local agents.

After a policy has been written the premium is presumed to be paid within sixty days. We must see that it is collected, and we compute it. The rate of premium on the policy is checked by us. A daily report is submitted to the Board of Underwriters, and it is again checked there. We compute the local agent's commission, and likewise our own commission. We make up such statements as are rendered between ourselves and the local agents. It is our duty to see that the premiums are actually collected. We remit to our companies by monthly balances, and unless we collect the premium we lose it.

After a risk is accepted the matter of reinsurance is entirely in our hands. By reinsurance we mean this: If a line is written in excess of what the company or general agent believes advisable, on a cer-

(Testimony of Arthur M. Brown.)

tain risk, we must either reduce the amount of the policy or must reinsure the excess in other companies. In 99% of the cases this reinsurance is effective. A [147] "treaty company" is a reinsurance company, which in most instances obtains the first line of reinsurance above the net line of the parent company. That is by arrangement between the parent company and the treaty, and we are advised of the arrangement. There is a very large amount of reinsurance that is not controlled by treaty arrangement. Where there is a treaty arrangement we must exercise judgment on behalf of our company as to the amount of reinsurance with the treaty. Where there is no treaty we determine the amount of reinsurance and with whom we are to reinsure. We control the reinsurance entirely. We do not get any further compensation when we reinsure a line. Sometimes we reinsure within our own organization, that is, reinsure one of our companies in another of our companies. Some reinsurance is written outside of our office by companies not represented by us. We arrange for the payment of premium when reinsurance is obtained, and should it be cancelled we are charged with the function of seeing that repayment is made. The whole matter is entirely in our charge. We are paid no further compensation, but all the services included within the original rates I mentioned.

After a policy has been written by a local agent we very often change the reinsurance without changing the primary policy itself. We may give a com-

(Testimony of Arthur M. Brown.)

pany a portion of the reinsurance and it may cancel it and we have to replace it. Very often [148] after a policy is written which did not require reinsurance, we get rid of the risk or protect it by reinsurance, without cancelling the policy. If our company were to get a full net line and later the agent would give the company another line on the same risk we would have to reinsure it. We determine that within a certain limitation only so much by way of risk should be assumed, as in a given building. If the first risk in that building were a millinery store, and we were later offered a hardware store, we would consider that a better risk, and if the limit had already been reached with the millinery store we would be able to take the hardware store by reinsuring the millinery store outside our organization if we could. That would be an occasion of reinsurance which had nothing to do with the writing of the original policy, and there is no extra compensation received by us for that.

We report our business to the home office once a month. A bordereau is a *résumé* of the month's business. This is a bordereau of return premiums, cancellations and endorsements for the Globe & Rutgers Fire Insurance Company for June, 1927. It is one of the forms of reports we get up for our companies and shows in detail, by the general agency, and by the state, the gross and net writings of the company, cancellations, return premiums and reinsurance. It shows by policy number and company [149] every transaction had. For each nature of transaction, monthly, for the year.

(Testimony of Arthur M. Brown.)

Mr. DUNNE.—If your Honor please, there is, of course, a very well-recognized rule of evidence that when accounts are long and complicated and unwieldly, it is competent for the parties to introduce in evidence summaries. We offer at this time to the Government to permit them to inspect any of the records that we have here, or in our office in San Francisco, and shall show that these records have already been investigated, and I shall ask the record to show one of these bordereaus for one company.

WITNESS.—(Continuing.) This is for one company for the months of April, May and June, 1927, showing the full detail of the transactions of the company by state, agency and policy number—a complete record for every dollar written and every return premium, showing reinsurance and cancellations, as well as new business.

Mr. DUNNE.—I will ask the record to show that this one bordereau in those three months for one company, for this year, is a book about 2½ feet long, I should say about 14 inches wide and about 6 inches thick, and weighing about 25 or 30 pounds. I will have to prove the figures eventually as to the earned commissions. They will not appear in these books, but these books, in the first place, show the records of the services performed, [150] and, in the second place the figures will come in and I want this matter in the record to show that these records are so voluminous that we could not have them here.

(Testimony of Arthur M. Brown.)

WITNESS.—(Continuing.) We make up yearly reports for our companies.

Edward Brown & Sons are the only general agents in the United States who are permitted to give a form of certificate of authority which is in their own name, such as that introduced in evidence here (Petitioner's Exhibit 8). Everywhere else the certificate is required to be in the name of the company.

In the reports to the companies we show business written, reinsurance, cancellations, return premiums, reinsurance losses, and premium income. We have settlement sheets and show expense of advertising, supplies and litigation. We maintain a statistical department for giving this information. We receive no extra compensation for this. When it is necessary to supply local authorities, municipal, state or federal, with reports, we prepare these on behalf of our companies, and we take care of payment of local license fees, taxes and things of that sort. Our remittances and dealings with our companies are strictly on a net basis. They have nothing to do for themselves except that two of our companies do pay state taxes directly.

We handle supplies for ourselves and our local agents, and for this purpose maintain a printing press. That [151] covers all of the necessary forms for writing insurance, except policy blanks and advertising matter.

After a policy has been written it is quite often necessary to change the terms. This is done by en-

(Testimony of Arthur M. Brown.)

dorsement. Thus if insured property is sold the insurance can be transferred by endorsement. No further commission is paid to us for that endorsement. When an endorsement is put on there are three possible results; it may be without change in premium; it may be with decrease in premium, in which event we refund that proportion of our overriding commission, and it may be with increase in premium, in which case we obtain our overriding commission. This last is the only time, after a policy is written, when our commission is changed by the receipt of further commissions, except in the case of industrial accident policies where the premium is determined at a later time, and an additional premium is paid so that the provisional premium will come up to the rate required. We take care of the mechanics of computing the premiums, and that is all gone over again just as I have described in the case of the original writing.

If a policy is cancelled by the assured we pay to the assured the short rate return premium without drawing on our company but out of our own funds. We do not keep any bank accounts for the companies except for one, the Svea. In the event of cancellation of reinsurance we take care of the details of the return commission.

[152] We control the cancellation of policies for the companies. In the event the premium is returned to the assured on a prorated basis we pay it back, drawing our own checks.

While a policy is in force we must perform ser-

(Testimony of Arthur M. Brown.)

vice with respect to the risk. We have to very carefully watch all classes of risks in all localities to determine whether or not the business continues to be profitable. If a town should go down hill it is our duty to scrutinize the business, and if the conditions are not good we cancel of our own volition. The companies have no control over that; we exercise our own judgment entirely. In one instance after the business had been written and the premium paid, on hail insurance, there was a bad drought and we cancelled and returned the full amount of premiums, rather than subject the people to something they knew they could not recover. Part of the premium had already been earned. We did not consult our companies.

If there is a loss under a policy we adjust it, and after proofs of loss are received, make necessary payments. At times we make thorough investigations requiring months, and we determine whether or not a particular loss shall be paid. We do not refer these matters to the companies, and in the event of threatened litigation we determine whether or not we shall continue to refuse to pay. In the event of litigation we control it, [153] but the companies pay the legal fees and costs of litigation. We receive no compensation for our own services in connection with that litigation. We have nothing to do in relation to our companies other than making net remittances to them, after we have taken care of all new business, reinsurance, cancellations, return premiums, collection of returned reinsurance, and

(Testimony of Arthur M. Brown.)

the payment of costs, losses and expenses. We never consult with them on any details—only on general matters of policy.

We have invested about $250,000 in the business of Edward Brown & Sons. Occasions have arisen when we have remitted to our companies such amounts that future contingencies arose which did not leave on hand money to their credit sufficient to cover it, and we had to go out and borrow money to take care of expenses and payments to our companies, and paid interest on it. We are not reimbursed for that by our companies, but it is included in the original commission paid.

We exercise constant supervision over risks, so we can determine whether or not risks shall be accepted. We send our engineers and fieldmen around to various localities to inspect almost every mercantile and manufacturing risk we have. We watch very carefully the markets and general conditions all over our territory. In case anything seems extraordinarily bad we discharge the man there and investigate. We investigate and keep track of new buildings and changed conditions. We keep detailed maps of the whole [154] territory over which we have jurisdiction for our companies. We belong to credit rating bureaus, and check up against the risk every moral hazard, and financial standing. Rates are determined by the Board of Underwriters, and we represent our companies on that Board. Over the period we are discussing we have a peak

(Testimony of Arthur M. Brown.)

in the writing of fire insurance which comes in the summer months.

Special pools are pools of companies for the purpose of taking care of extraordinary or unusual hazards. The logging pool interests of Oregon and Washington take care of the immense amounts required in covering the logging equipment in the woods and the timber as it is cut, which is too large for one company. We determine whether our companies will go into pools, without reference back to the home office.

In fact, we do not refer anything back to the home companies.

Our relation as general agent for the United States Merchants & Shippers terminated three or four years ago. After that policies written through our office were cancelled, and in the event of such cancellations we return the unearned portion of our commissions—that portion of the commissions which is related to the unearned portion of the premium.

Cross-examination by Mr. MEACHAM.

My son is thirty, I think. He first came into the office as a clerk for several years, prior to 1924, on a [155] salary basis, not a partner.

When we cancelled the hail insurance in Montana that I spoke of, and returned the premiums, there was no obligation to do so. It was a form of advertising of our business, if you like to put it that way.

Thereupon counsel for respondent, pursuant to subpoena and pursuant to request of counsel for

petitioner, produced the revenue agent's report as to petitioner's income for the year 1923, which was dated May 6th, 1927, and it was stipulated that said report was made by the agent of the Internal Revenue Department, who was employed by the Government for the purpose of examining the books of the taxpayer and making the report on that subject back to the Commissioner of Internal Revenue, and that the report produced was such report. Counsel for petitioner then offered in evidence the following from page 4 of said report:

> "The accounts in connection with the general insurance agency of taxpayer may be said to be kept on an accrual basis."

Petitioner then offered, not as binding on him, but simply as the revenue agent's report itself, and as showing what he handed to the Commissioner, and upon what the Commissioner acted, the whole report. Respondent objected to the report on the ground that it was incompetent, irrelevant and immaterial, and had no bearing on the issues of the case.

[156] EXCEPTION No. 1.

Thereupon said objection was sustained upon the ground of incompetency. To such ruling petitioner then and there duly excepted and now excepts and assigns the same as error.

EXCEPTION No. 2.

Thereupon counsel for respondent moved to strike out the portion of the report read into the record. Counsel for petitioner objected to said motion upon the ground that the objection should have preceded

the offer. Thereupon said motion was granted, and the said matter ordered stricken, to which said ruling petitioner then and there duly excepted and now excepts and assigns the same as error.

Said report was subsequently, and as hereinafter appears, marked Petitioner's Exhibit No. 17 for identification.

Thereupon counsel for respondent, pursuant to subpoena, and pursuant to demand, produced the individual income tax return for the calendar year, 1923, of petitioner, Arthur M. Brown, and thereupon petitioner offered the same in evidence, and the same was received in evidence, as Petitioner's Exhibit No. 9, and was so marked. Said exhibit not being in form susceptible of reproduction here or in a printed transcript, it is respectfully prayed that the original be attached hereto and to the transcript on appeal herein, and be forwarded to the [157] Circuit Court of Appeals for the Ninth Circuit with the transcript of record herein.

Thereupon, pursuant to similar subpoena and request, counsel for respondent produced the original individual income tax return of petitioner for the year, 1925, and thereupon petitioner offered the same in evidence, and the same was so received, as Petitioner's Exhibit No. 10, and was so marked. For the same reasons as in the case of Exhibit No. 9, it is prayed that said exhibit be made a part of the transcript on appeal herein, as in the case of Petitioner's Exhibit No. 9.

Thereupon, counsel for petitioner being unable to produce the original partnership return for the year,

1925, petitioner, without objection, offered, and there was received in evidence, as Petitioner's Exhibit No. 11, and so marked, a copy thereof, and it was thereupon stipulated and ordered that counsel for respondent might substitute therefor a photostatic copy of the original. For the same reasons as in the case of Exhibit No. 9, it is prayed that said exhibit (or a photostatic copy of the original in the event such was substituted for the original exhibit) be made a part of the transcript on appeal herein, as in the case of Petitioner's Exhibit No. 9.

Thereupon, pursuant to similar request and subpoena, as in the case of Petitioner's Exhibit No. 9, counsel for respondent produced the original income tax return of petitioner [158] for the, year 1926, and thereupon petitioner offered the same in evidence, and the same was so received, as Petitioner's Exhibit No. 12, and was so marked. For the same reasons as in the case of Exhibit No. 9, it is prayed that said exhibit be made a part of the transcript on appeal herein, as in the case of Petitioner's Exhibit No. 9.

Thereupon, counsel for petitioner being unable to produce the original partnership return for the year, 1926, petitioner, without objection, offered, and there was received in evidence, as Petitioner's Exhibit No. 13, and so marked, a copy thereof, and it was thereupon stipulated and ordered that counsel for respondent might substitute therefor a photostatic copy of the original. For the same reasons as in the case of Exhibit No. 9, it is prayed that said exhibit (or a photostatic copy of the original in the event

such was substituted for the original exhibit) be made a part of the transcript on appeal herein, as in the case of Petitioner's Exhibit No. 9.

Thereupon there was identified, offered and received in evidence as Petitioner's Exhibit No. 14, and so marked, a copy of respondent's so-called sixty-day deficiency letter to petitioner with respect to petitioner's tax for the year, 1923, which said letter was and is as follows:

PETITIONER'S EXHIBIT No. 14.

"TREASURY DEPARTMENT.
Washington.

"IT:FAR:B-2.
"LCT-60D.

"Dec 22, 1927.

[159] "Mr. Arthur M. Brown,
"200 Bush Street,
"San Francisco, California.

"Sir:

"The determination of your income tax liability for the year 1923, discloses a deficiency of $17,923.03, as shown by the attached statement.

"In accordance with the provisions of Section 274 of the Revenue Act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United State Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the Board within the 60-day period, not counting Sunday as the sixtieth day.

"Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final decision on such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the Collector of Internal Revenue. No claim for abatement can be entertained.

"If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the inclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:FAR:B-2-LCT-60D.

"In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

"Respectfully,

"D. H. BLAIR,

"Commissioner.

"By _____,

"Deputy Commissioner.

"Inclosures:

"Statement:

"Form A.

"Form 882 SDG-2.

[160] "STATEMENT.

"IT:FAR:B-2.
"LCT-60D.

"Dec. 22, 1927.

"In re: Mr. Arthur M. Brown,
"200 Bush Street,
"San Francisco, California.

"Year.	Deficiency in Tax.
"1923.	17,923.03.

"The report of the Internal Revenue Agent in charge at San Francisco, California, transmitted to this office under date of July 22, 1927, has been reviewed with the following exception:

"The deduction of $3,185.15 for Christmas Gifts to employees has been allowed. This deduction was an ordinary and necessary business expense of the concern when it was made and it was recommended by the Internal Revenue Agent in Charge that the amount be allowed.

"The revenue agent has been sustained in regard to the disallowance of the deduction of $52,971.96, representing a reserve for return commissions. Insurance companies are entitled under the Law to set up such reserves, and you contend that being in the insurance business you would be entitled to the same method of computing income. In this connection, you are advised that the provisions of the Law governing insurance companies for the purpose of setting up reserves is statutory. Your business is

not an insurance company inasmuch as you are acting as an agent in writing insurance policies for which you receive a commission. It, therefore, cannot be held that you are entitled to the same provisions as an insurance company.

"It has been held by this office that the deduction of $3,000.00 paid to Edith H. Holton, is a capital expenditure and is not deductible from income. It has also been held by this office that the deduction for a payment to the Industrial Association of San Francisco, is not allowable.

[161] "It is noted that all other adjustments as made by the Revenue Agent have been conceded by you.

"Net income originally reported			$35,563.20
"Salaries reported		$18,000.00	
"As adjusted		21,600.00	
"Income from business reported	$15,590.75		
"As adjusted	73,668.11		58,077.36
"Other deductions as claimed	$2,413.36		
"As adjusted	2,363.36		50.00
"Total income as adjusted			$97,290.56
"Dividends and exemption			6,479.20
"Amount subject to normal tax			$90,811.36

"Total tax		$28,298.57
"25% Reduction, Revenue Act of 1924		7,074.64
"Net tax assessable		$21,223.93
"Tax assessed	$4,401.20	
"25% Reduction, Revenue Act of 1924	1,100.30	3,300.90
"Deficiency		$17,923.03

"Payment of the tax should not be made until bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

"SDG–2."

[162] Thereupon there was identified, offered and received in evidence, as Petitioner's Exhibit No. 15, and so marked, respondent's so-called sixty-day deficiency letter to petitioner, dated February 7th, 1929, and dealing with petitioner's tax for the year 1926, and as Petitioner's Exhibit No. 16, and so marked, respondent's so-called sixty day deficiency letter to petitioner, dated April 28th, 1928, and dealing with petitioner's tax for the year 1925. Said letters (but not the statement attached) are in substantially the form of the letter forming part of Petitioner's Exhibit No. 14, and the same were attached, respectively, to the petitions in the proceedings numbered herein Docket Nos. 43,432 and 39,157, and for that reason the same are not repeated here, but reference to the same, as attached to said petitions, is hereby made, and it is prayed that the original of said exhibits Nos. 15 and 16 be made a part of the transcript on appeal herein and be forwarded to the Circuit Court of Appeals for the Ninth Circuit with the transcript of record herein.

TESTIMONY OF CHARLES W. WHITE, FOR PETITIONER.

CHARLES W. WHITE, called as a witness on behalf of petitioner, being first duly sworn, testified as follows:

Direct Examination by Mr. DUNNE.

I looked at the bordereau shown Mr. Brown, and called to your attention that he was in error as to what it covered —[163] it covers only premiums and return premiums. I am chief accountant for Edward Brown & Sons. That pile of books over there are the records of the business of the firm, and this pile of papers are monthly reports to the insurance companies represented by Edward Brown & Sons of transactions for the month. In making settlement with the companies the settlement is made on the basis of these reports which are summaries by the month of all business written by Edward Brown & Sons. They show new business, cancellations, return premiums, reinsurance, return reinsurance, and the computation of what is due Edward Brown & Sons.

Thereupon, counsel for petitioner stated that the records just identified were those from which the figures to be used were taken, and from which the summaries Mr. Logan would testify to were taken, and that in view of their bulk he preferred not to offer the documents identified; that the only purpose was to substantiate the computations and set-ups made from them by Mr. Logan.

(Testimony of Charles M. White.)

WITNESS.—(Continuing.) The figures for the year, 1923, appear in the Journal, which is among the books here.

EXCEPTION No. 3.

There was then identified and offered in evidence on behalf of petitioner, the reports made by the agent of the Internal Revenue Department with respect to petitioner's income for [164] the years 1925 and 1926, corresponding to Exhibit No. 17 for identification for the year, 1923. The receipt in evidence of said reports was objected to upon the ground that the same were incompetent, and said objection was sustained and the said reports were not receive in evidence, to which ruling petitioner then and there duly excepted, and now excepts, and assigns the same as error, and the said reports were then marked respectively for identification, Petitioner's Exhibits Nos. 18 and 19 for identification. The agent's report for the year, 1923, theretofore referred to as hereinabove appears was then marked Petitioner's Exhibit No. 17 for identification. It is prayed that the original of said reports be attached to the transcript herein and be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit with said transcript, and as a part thereof, and as a part of this statement of evidence.

TESTIMONY OF KENNETH N. LOGAN, FOR PETITIONER.

KENNETH N. LOGAN, called as a witness on behalf of petitioner, being first duly sworn, testified as follows:

Direct Examination by Mr. DUNNE.

I am a certified public accountant, duly licensed to practice as such in the State of California since 1922, and practicing my profession in San Francisco. I had been engaged in the business of accountancy before that—since about 1914—and have had experience in auditing books of insurance companies. At one time I [165] spent approximately eight months for the Board of Fire Underwriters auditing the books of the insurance companies in San Francisco under their jurisdiction. I have been engaged by Mr. Brown as a certified public accountant in connection with the pending matter, and in that connection examined the original books of Edward Brown & Sons and have drawn certain figures from them. This paper headed "Edward Brown & Sons prorate of overriding commissions of Arthur M. Brown's interest" from August 1st, 1922, to December 31st, 1923, is a summary which I prepared and had prepared under my immediate supervision of the amounts of commission which would accrue to Arthur M. Brown on policies written by his companies from

(Testimony of Kenneth N. Logan.)

August, 1922, to December, 1923. Those figures were drawn from the settlement sheets that are prepared monthly for the companies, and I obtained those figures from the books and sheets which Mr. White has just identified.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 20, was so marked and was and is as follows:

[16]

EDWARD BROWN & SONS

Prorate of Overriding Commissions of Arthur M. Brown's Interest
Years 1918-1923

	TOTAL	Herbert H.Brown's Interest	Arthur M. Brown's Interest	1918	1919	1920	1921	1922	1923	1924	1925	1926	1927	1928
1 Year Business Written in														
1922	107,729.35	25,136.85	82,592.50					41,296.25	41,296.25					
1923	137,213.15		137,213.15						68,606.57	68,606.58				
5 Year Business Written in														
1920	76,509.45	30,603.77	45,905.66			7,650.94	15,301.88	15,301.88	7,650.96					
1921	53,175.81	21,270.32	31,905.49				5,317.58	10,635.16	10,635.16	5,317.59				
1922	71,846.17	16,694.10	54,852.07					9,142.01	18,284.02	18,284.02	9,142.02			
1923	91,706.64		91,706.64						15,284.44	30,568.88	30,568.88	15,284.44		
5 Year Business Written in														
1918	6,275.47	2,510.19	3,765.28	376.53	753.06	753.06	753.06	753.06	376.51					
1919	4,067.93	1,627.17	2,440.76		244.08	488.15	488.15	488.15	488.15	244.08				
1920	3,713.17	1,485.27	2,227.90			222.79	445.58	445.58	445.58	445.58	222.79			
1921	4,291.31	1,716.52	2,574.79				257.48	514.96	514.96	514.96	514.96	257.47		
1922	3,843.22	780.08	2,563.14					256.31	512.63	512.63	512.63	512.63	256.31	
1923	3,804.85		3,804.85						380.49	760.97	760.97	760.97	760.97	380.48
Special 1922	584.80	136.44	448.36					448.36						
Special 1923	3,968.67		3,968.67						3,968.67					
TOTALS	566,760.35	101,687.81	465,072.54	376.53	997.14	9,114.94	22,563.73	78,385.00	168,444.39	125,256.29	41,722.25	16,815.51	1,017.28	380.48

*40% Interest to date of death, July, 1922

(EXHIBIT #20)

(Testimony of Kenneth N. Logan.)

[167] WITNESS.—(Continuing.) The books of Edward Brown & Sons for the years, 1923, 1924, 1925 and 1926—and back to 1918—are on an accrual basis. The entries are not made by showing income and disbursements as cash is actually received and disbursed, but entries are made when business is written, and the amount of commissions and premiums which would be computed on the policies are set up on the books, and the entry made to the commission and premium accounts at that time, irrespective of the date of those payments. The entries with respect to premiums due the home offices and with respect to commissions due Edward Brown & Sons do not relate to the time when actual remittances are made. Current monthly items of expense are set up as paid.

Petitioner's Exhibit No. 20 shows in the first column on the left the year in which policies are written and the length of time for which they run. It is divided into four sections—policies having one year life, three-year policies, five-year policies, and special policies or commissions on special policies. Under the first caption, one year business, we have commissions that apply to policies written in 1922 and 1923. The amounts of commissions are under the column headed total. This paper headed, prorate of overriding commissions of

Arthur M. Brown, from August 1st, 1922, to December 31st, 1923, is a summary of the commissions which accrued on policies written during that time.

[168] Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 21, was so marked and was and is as follows:

[16]

EDWARD BRO N & SONS

Prorate of Overriding Commissions of Arthur M. Brown
from August 1, 1922 to December 31, 1923

	Total	1922	1923	1924	1925	1926	1927	1928
1 Year Business								
*Written in 1922	44,887.20	9,351.60	35,535.70					
1923	137,213.15		68,606.57	68,606.58				
3 Year Business								
*Written in 1922	29,810.90	2,070.20	9,936.97	9,936.97	7,866.76			
1923	91.706.64		15,284.44	30,568.88	30,568.88	15,284.44		
5 Year Business								
*Written in 1922	1,393.00	58.04	278.60	278.60	278.60	278.60	220.56	
1923	3,804.85		380.49	760.97	760.97	760.97	760.97	
Special	3,968.67		3,968.67					
	312,784.41	11,479.74	133,991.44	110,152.00	39,475.21	16,324.01	981.53	380.48

*From August 1, 1922 to
December 31, 1922.

(EXHIBIT #21)

(Testimony of Kenneth N. Logan.)

[170] WITNESS.—(Continuing.) To the left this is divided into one year, three year and five year groups, indicating the length of time that the policy is to be in force, and the figures all refer to policies written from August 1st, 1922, to the end of 1923. The next column "Total" represents total commissions to accrue on those policies, and represents the total commissions that would be received and retained by Edward Brown & Sons if the policies written during that period went through to their natural expiration without cancellation. The next column headed "1922" represents the amount of commissions which would be earned on an accrual basis in the year, 1922. I am familiar with the form of report required to be made by insurance companies to the Insurance Commissioners of the various states, and referred to in the Revenue Acts of 1924, 1926 and 1928. I am familiar with the method used on those reports for prorating premiums to show when they are earned. On one-year policies the total premium is divided in two, and one-half is considered earned in the current year and one-half in the subsequent year. As to three-year policies earnings are segregated one-sixth to the first year, one-third to the second, one-third to the third, and one-sixth to the fourth, and on five-year business one-tenth to the first year, one-fifth to the second, one-fifth to the third, one-fifth to the fourth, one-fifth to the fifth, and one-tenth to the sixth. In making my prorations I followed that method. I have not prorated over a

(Testimony of Kenneth N. Logan.)

period beyond the year in which the business was written any noncancellable policy. We consider one-year [171] business as being one year or less. Hail insurance is seasonal business. Practically all policies expire on September 15th, and a few on October 15th, and practically none run beyond that. I have not prorated such commissions or any commissions on cargo insurance. The sum of the figures appearing under the heading "1922" and "1923" represent the total as it appears under the "Total" column. The total figure of $44,887.20 allotted $9,351.50 to 1922, and $35,535.70 to 1923 was allotted as follows: 1922 had five months to run. We have taken the ratio of the five months period, which means that an average policy written in that five months period is the two and a half months policy, and have applied to 1922 that proportion, and have carried over the balance to 1923, when the total would expire. That method is the same as used in reports required by Insurance Commissioners and referred to in the Revenue Act. On the next line under one-year business written in 1923 is a total of $137,213.15, representing total commissions accrued to Edward Brown & Sons on one-year business written in 1923. On that line nothing is carried over from under "1922" because the policies did not commence until 1923. Under 1923 I have the figure $68,606.57, and the same with 1¢ difference under 1924. The figures are half the total, so that in 1923 on one year policies we have considered as earned in that year one-half of the

(Testimony of Kenneth N. Logan.)

total on the policies. Using exactly the same method I have, in the same way, shown the total commissions for policies written for three year and for five year business, prorated over succeeding years [172] in the same manner and following the method described by the Insurance Commissioners of the various states.

This paper headed "Prorate of overriding commissions from January 1, 1924, to December 31, 1924, including carry over from August 1, 1922" was prepared by me and under my immediate supervision, and I got the figures from the same source as I got the other figures, except for difference in years. As to this paper and as to Petitioner's Exhibits 21 and 20, and as to the figures in the total columns I have made no change whatever from the figures as they appear on the books of Edward Brown & Sons. The prorates do not appear on the books—the mechanical work of prorating I did. The actual figures used on that basis are exactly the same as appear on the books.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 22, was so marked and was and is as follows:

[173]

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1,1924 to December 31,1924
including carry over from August 1, 1922

	Total	1924	1925	1926	1927	1928	1929
Balance from 1923 Schedule							
For year 1924	$110,152.00	$110,152.00					
1925	39,475.21		$ 39,475.21				
1926	16,324.01			$ 16,324.01			
1927	981.53				$ 981.53		
1928	380.48					$ 380.48	
	$167,313.23						
Commissions on Policies written in 1924							
On 1 year Policies	133,507.36	66,753.68	66,753.68				
" 3 year Policies	84,198.80	14,033.13	28,066.27	28,066.26	14,033.14		
" 5 year Policies	1,944.17	194.42	388.83	388.83	388.83	388.83	194.43
Special Commissions	1,211.98	1,211.98					
	$388,175.54	$192,345.21	$134,683.99	$44,779.10	$ 15,403.50	$ 769.31	$ 194.43
Less 1/6 Interest to A.M.Brown, Jr.		32,057.54					
Corrected Earned Commission 1924 of Arthur M. Brown		$160,287.67					
Commission Recorted		$223,721.60					
Svea Farm Profit		694.85	$224,416.45				
Return Commission Dec. 31, 1923		$ 52,971.96					
Return Commission Dec. 31, 1924		49,417.82	3,554.14				
			$220,862.31				
Less 1/6 to A. M. Brown, Jr.			36,810.38				
Commission, per Agent			$184,051.93				
Corrected, as above			160,287.67				
Net Adjustment to Agent's Net Income			$ 23,764.26				

(EXHIBIT #22)

(Testimony of Kenneth N. Logan.)

[174] Petitioner's Exhibit No. 22 shows the unearned proportion of the commission on policies written prior to 1924 carried into 1924 and later years, and in addition commissions on policies written in 1924. From that you can draw off figures which will show the unearned commissons at the end of 1924, commencing with business written after August 1st, 1922. From Exhibit No. 21 the unearned commissions in connection with the business at the beginning of the year, 1923, was $11,479.74. From that exhibit the net commissions accrued for that year would be the total of those three divisions of one, three and five year, and special commissions, which totals $263,693.31. On those figures at the end of 1923 $167,313.23 was earned. This was done by comparing the carry-over into Exhibit 22 and totaling that. The carry-over of unearned commissions at the end of 1923, as shown by Exhibit No. 21, corresponds with the carry-over of unearned commissions that is carried into the year, 1924, on Exhibit No. 22. This paper headed "Edward Brown & Sons. Prorate of overriding commissions from January 1, 1925 to December 31, 1925 including carryover from August 1, 1922," is the same summary for the year, 1925, as Exhibit No. 22 was for the year 1924, prepared in exactly the same way.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 23, was so marked and was and is as follows:

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1, 1925 to December 31, 1925
including carry over from August 1, 1922

	Total	1925	1926	1927	1928	1929
Balances from 1924 Schedule for Year 1925	$134,683.99	$134,683.99				
1926	44,779.10		44,779.10			
1927	15,403.50			15,403.50		
1928	769.31				769.31	
1929	194.43					194.43
Commissions on Policies written in 1925						
On 1 year Policies	145,478.88	72,739.44	72,739.44			
" 3 year Policies	92,359.56	15,393.26	30,786.52	30,786.52	15,393.26	
" 5 year Policies	40.89	8.18	8.17	8.18	8.18	8.18
Special Commissions	1,430.65	1,430.65				
	$436,088.51	$224,239.14	$148,296.89	$ 46,181.84	$ 16,154.39	$ 186.25
First one-half Year 1925		$112,119.57				
Less 1/6 to A. M. Brown, Jr.		18,686.59				
			$ 93,432.98			
Second one-half Year 1925		$112,119.57				
Less 1/4 to A. M. Brown, Jr.		28,029.89				
			84,089.68			
Corrected Earned Commission to Arthur M. Brown			$177,522.66			
Commissions 1925		$237,714.69				
Svea Farm Profit		1,779.49	235,935.20			
Return Commission Dec. 31, 1924		$ 49,417.82				
" " " 31, 1925		52,710.80	3,292.98			
			$239,228.18			
Less 5/24 to A. M. Brown, Jr.			49,839.22			
			$189,388.96			
Corrected as above			177,522.66			
Net Adjustment to Agent's Net Income			$ 11,866.30			

(EXHIBIT #23)

(Testimony of Kenneth N. Logan.)

[176] Exhibits Nos. 21, 22 and 23 all carry into the computations a net arrived at after taking care of cancellations and return commissions. On Exhibit No. 23 I have carried in as unearned commissions on business written prior to 1925 the figure shown as unearned commission at the end of 1924 on Exhibit 22, and have then shown the business during 1925 and the commission unearned at the end of 1925.

TESTIMONY OF ARTHUR M. BROWN, IN HIS OWN BEHALF (RECALLED).

The witness was then temporarily withdrawn, and ARTHUR M. BROWN, the petitioner, previously sworn on his own behalf, was recalled and testified as follows:

Direct Examination by Mr. DUNNE.

These papers dated January 1, 1924, January 1, 1927, and January 1, 1929, are the papers I referred to yesterday in discussing my son's participation in the business of Edward Brown & Sons.

Thereupon, all three documents were handed to counsel for respondent for inspection, and the paper dated January 1, 1924, was read in evidence as follows:

"January 1, 1924.

"Salary Agreement Edward Brown & Sons.

"Mr. Arthur M. Brown and Mr. Arthur M. Brown, Jr., [177] doing business as Edward

(Testimony of Arthur M. Brown.)

Brown & Sons hereby agree that from date the joint salaries paid to the partners above named shall be thirty-six thousand dollars per annum, of which Mr. Arthur M. Brown is to received five-sixths or thirty thousand dollars, and Mr. Arthur M. Brown, Jr., is to receive one-sixth, or six thousand dollars.

"ARTHUR M. BROWN.
"ARTHUR M. BROWN, Jr.

WITNESS.—(Continuing.) From my experience in the insurance business I would say that approximately the general ratio of cancellations to business written, depending on the year, runs between 20% and 25%.

Cross-examination by Mr. MEACHAM.

This last exhibit was the only agreement as to partnership between myself and my son, at the time. Prior to January 1, 1927, there was no definite written agreement. He was not a partner in 1923. I think he was a full partner from 1924 on. That was an oral understanding. In 1924 he had a salary interest, and I believe the books will show also an interest in the profits beyond that. In 1923 he had no interest in the profits. It is not my recollection that on my brother's death [178] I took my son into the firm in partnership. To the best of my recollection I would say he was not a partner during 1923.

TESTIMONY OF KENNETH N. LOGAN, FOR PETITIONER (RECALLED).

KENNETH N. LOGAN, previously sworn on behalf of the petitioner, was recalled and testified as follows:

Direct Examination by Mr. DUNNE (Continued).

I have examined the books of Edward Brown & Sons to find what participation in the profits the books reflect. This is a journal used to make the closing entries for each year and is one of the books Mr. White identified as being one of the books of Edward Brown & Sons. The first figure showing the partnership participation of Arthur M. Brown, Jr., is in the closing of the profits for the year, 1924, showing Mr. Brown receiving $21,373.88, Arthur Mr. Brown, Jr., $4,274.77, Mrs. Halton $3,000, and the children of Herbert H. Brown $6,000, making a total closing to profit and loss of $34,648.65. The next entry for closing is for the year, 1925, showing Arthur M. Brown $4,759.90, A. M. Brown, Jr., $1,586.63, Mrs. E. Halton $3,000, children of H. H. Brown $3,000, total $12,346.53, charged to profit and loss. There was a change in rate of participation shown by computation of the closing entries. The exact point of change does not show from these [179] figures. At the end of 1926 the closing figures are A. M. Brown $5,600.43, A. M. Brown, Jr., $1,866.81, and Mrs. E. Halton $2,200. The charge to profit and loss is a total of $9,667.24. The closing entries for

(Testimony of Kenneth N. Logan.)

1923 are charged to profit and loss $11,383.63, credit A. M. Brown, Jr., $2,383.63, children of H. H. Brown $6,000, Mrs. E. Halton $3,000. That is the closing of personal accounts. The final closing of the net profit is charged to profit and loss and to A. M. Brown $7,150.90. Going back to 1922 there is charged to profit and loss $12,432.52, credit A. M. Brown $9,258.19, and no showing of any participation by Arthur M. Brown, Jr. There is another credit of $1,424.33, and a credit to Mrs. E. Halton of $1,750.

A short rate cancellation is a term used in insurance to designate a return premium on cancellations on a basis other than a direct *pro rata* of the premium to the life of the policy and is in favor of the company. Those short rate cancellations have been carried into the figures that I am using, and all of the figures that I can have used as to cancellations are dollars and cents figures and carry with them whatever adjustment is necessarily made because of short rating. This paper headed "Edward Brown & Sons. Prorate of overriding commissions from January 1, 1926, to December 31, 1926, including carry-over from August 1, 1922," is a summary computation I computed from the books for the year, [180] 1926, showing carry-over of unearned commissions from 1925, and the current business written during 1926, prepared on the same basis as Exhibits 21, 22 and 23.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 24, was so marked, and was and is as follows:

[18T

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1,1926 to December 31,1926
Including carry over from August 1, 1922

	TOTAL		1926	1927	1928	1929
Balance from 1925 Schedule for 1926	$148,296.89		$148,296.89	$	$	$
1927	46,181.84			46,181.84		
1928	16,154.39				16,154.39	
1929	186.25					186.25
Commissions on business written in 1926						
on 1 year Policies	$141,042.51		$ 70,521.26	$ 70,521.26		
" 3 year Policies	107,929.05		17,988.17	35,976.35	35,976.35	17,988.18
" 5 year Policies	477.08		119.27	119.27	119.27	119.27
Special	6,593.25		6,593.25			
	$465,907.10		$243,280.29	$152,560.18	$ 52,011.47	$ 18,055.16
Less 1/4 to A. M. Brown, Jr.			60,820.07			
Corrected Earned Commission Arthur M. Brown 1926			$182,460.22			
Commissions 1926		$253,881.21				
Sves Farm Profit		741.25	$253,139.96			
Return Commissions Dec. 31, 1925		$ 52,710.80				
" " Dec. 31, 1926		54,658.67	1,947.77			
			$255,087.73			
Less 1/4 to A. M. Brown, Jr.			63,771.93			
Commissions, per Agent's Report			$191,315.80			
Corrected, as above			182,460.22			
Net Adjustment to Agent's Net Income			$ 8,855.58			

(EXHIBIT #24)
209

(Testimony of Kenneth N. Logan.)

[182] WITNESS.—(Continuing.) As to Exhibits 21, 22, 23 and 24, the figures appearing under the word "Total" are the same as the corresponding figures appearing on the books of Edward Brown & Sons. It was not necessary for me to change any figure to make up those exhibits. I simply carried over the figures that appear on the books. Exhibit No. 24 shows the unearned portion of commissions on business written prior to 1926, and since August 1st, 1922, which is attributable to the year, 1926, and shows the portion of the commissions on business written in 1926, which was earned in 1926, and the portion on such business earned in years subsequent to 1926, on the same prorate basis I have already indicated. The unearned commissions at the beginning of the year, 1926, was $210,819.37, the same figure as shown by Exhibit 23 as the unearned commission at the end of 1925. The unearned commission at the end of 1926 was $222,626.81, and the net commission on business written during 1926 $255,087.73.

The closing entry read for December, 1922, of $1,424.33 was for the children of Herbert H. Brown, and the profits show a participation of Arthur M. Brown, Jr., for 1925 of one-fourth. The computations on Exhibit 23 have not been on the basis of one-fourth for Arthur M. Brown, Jr., all the way through, because the internal revenue agent examined the accounts for 1925 and found the interest of Arthur M. Brown, Jr., for the period from [183] January 1, 1925, to July 1, 1925, was a one-

(Testimony of Kenneth N. Logan.)

sixth interest, the same as it had been in 1924, and from July 1, 1925, to December 31, 1925, a one-fourth interest, and we have used those ratios so that the figures are in accordance with the report of the Internal Revenue Department. With reference to Exhibit No. 21 there is no explanation with reference to the participation of Arthur M. Brown, Jr. On Exhibit No. 22, beginning at the lower half, the figures on the line "Less one-sixth interest to Arthur M. Brown, Jr.," represent one-sixth of the total amount of commissions earned in 1924 by Edward Brown & Sons accruing to Arthur M. Brown, Jr. The figures we have been talking about above are total figures for Edward Brown & Sons, and these new figures are for the purpose of arriving at the interest of the taxpayer, the petitioner here. The entry corrected earned commission of 1924 of Arthur M. Brown is the subtraction from total earned commission of the partnership, of Arthur M. Brown, Jr.'s, interest, leaving the petitioner's interest. The figure $223,721.60 under that of commission reported represents the commission reported on the petitioner's personal income tax return for the year, 1924. The figure for "Svea profit" is a separate account not carried under overriding commission on the books but pertaining to the same type of income, and I have prorated that. The figure "Return commission December 31, 1923," represents the liability that was established on the books of Edward Brown & Sons at December 31, 1923, to take care of cancel-

(Testimony of Kenneth N. Logan.)

lations which would accrue, based on five years previous experience. That was a journal entry [184] on the books. Under that I have "Return commission December 31, 1924," which is the same type of figure for return commission liability in effect on December 31, 1924. By using these figures in this schedule we eliminate from the commission account the entry that was put into the commission account to adjust the liability feature as of the beginning and as of the end of the year, so that it leaves only a commission figure in the account. The figure under that, less one-sixth to A. M. Brown, Jr., is one-sixth of the net adjusted commission figure. The next entry, "Commission per agent," is the commission are reported by the revenue agent in his return for that year. Under that, "Corrected, as above," is carrying down the corrected earned commission of Arthur M. Brown for the year, 1924, as compared with the figure used by the agent. The last entry shows the net adjustment between the earned commission as reported in the agent's report and the corrected figure as determined from this schedule. This schedule is computed on the basis of proration of commissions over the period for which they are earned, including the carry-over from August 1, 1922. The figures on Exhibit No. 23 have the same explanation as those on No. 22, except that to bring the proper partnership interests into this schedule we had to divide the commissions into two parts, so that we would get one-sixth for Arthur M. Brown,

(Testimony of Kenneth N. Logan.)

Jr., in the first half of the year, and one-fourth in the second half, and the same is true for Exhibit No. 24, and on all three schedules the ultimate figure arrived at, at the bottom, is the net adjustment to the agent's net [185] income, if the commissions are to be taken on the strict accrual and *pro rata* basis. We have in court the original books of Edward Brown & Son, from which could be taken every figure necessary to make up these exhibits.

This paper headed, "Analysis of commission account," covers the years, 1924, 1925 and 1926, and for each year the same type of figures are set forth, so that if I explain one year I explain all three. In 1924 the first figure is overriding commission of $223,721.60, the figure on the books representing overriding commission in that year, to which I have added "Svea Farm Profit" $694.85, making a total as per the books of $224,416.45, for commissions. The next figure is return commission, December 31, 1923, the liability set up on the books of $52,-971.96, to take care of cancellation of business written in those years, in subsequent years. The next figure, return commission, December 31, 1924, is $49,417.82, set up for the same purpose. The difference between the two is $3,554.14, an entry made on the books reducing the amount of overriding commission in 1924 on the basis that the return commission balance at the beginning of 1923 was in excess of the balance at the end of 1924. The net figure of $220,862.31, therefore, represents the com-

(Testimony of Kenneth N. Logan.)

missions on policies written in the year, 1924, and is in agreement with the figures used by the revenue agent in computing the tax for that year. The purpose of this exhibit is to make corrections to indicate various entries, and to [186] show that the entries in the books tie in with the entries the agent made, and to show that the figures on the books and on the agent's report correspond, assuming both used the same method of computation.

Thereupon, the document referred was offered and received in evidence as Petitioner's Exhibit No. 25, was so marked, and was and is as follows:

PETITIONER'S EXHIBIT No. 25.

[187] ANALYSIS OF COMMISSION ACCOUNT.

1924	Overridnng Commissions.....	$223,721.60		
	Svea Farm Profit	694.85	$224,416.45	
	Return Commission 12/31/23.....	$52,971.96		
	Return Commission 12/31/24.....	49,417.82	3,554.14	
	Net Commission 1924.....			$220,862.31

1925	Overriding Commissions.....	$237,714.69		
	Svea Farm Profit.....	1,779.49	$235,935.20	
	Return Commission 12/31/24.....	$49.417.82		
	Return Commission 12/31/25.....	52,710.80	3,292.98	
				239,228.18
1926	Overriding Commissions.....	253,881.21		
	Svea Farm Profit.....	741.25	$253,139.96	
	Return Commission 12/31/25.....	$52,710.80		
	Return Commission 12/31/26.....	54,658.57	1,947.77	255,087.73

(Testimony of Kenneth N. Logan.)

[188] WITNESS.—(Continuing.) All of the figures on the last exhibit were obtained directly from the book of Edward Brown & Sons and the books are in court. I have prepared a computation of tax for each of the three years, 1923, 1925 and 1926, as it would result by using the so-called prorate method introduced as Exhibits 21 to 24, both inclusive.

Thereupon, the computation referred to was offered in evidence on behalf of the petitioner. To such offer respondent objected.

EXCEPTION No. 4.

Said objection was sustained, and said offer rejected, to which said ruling petitioner then and there duly excepted, and now excepts, and assigns the same as error. The computation so offered and rejected was then marked for identification as Petitioner's Exhibit No. 26 for identification, and was and is as follows:

PETITIONER'S EXHIBIT No. 26.

[189] COMPUTATION OF TAX FOR YEAR 1923.

Total Income as adjusted per 60 day Letter.....		$97,290.56
Less:		
Adjustment for Earned Income.....		
Commission Income per Agent.....	$236,693.31	
As adjusted by prorate.....	133,991.44	
	$102,701.87	
Adjustment for Edith H. Halton.....	3,000.00	105,701.87
Net Loss		$ 8,411.31
No Tax.		
Previously Assessed.....	$ 4,401.20	
Less: 25% Reduction Revenue Act of 1924.....	1,100.30	$ 3,300.90
Refund Due and Interest.		$ 3,300.90

Commissioner of Internal Revenue.

[190] COMPUTATION OF TAX FOR YEAR 1925.

Net Income per 60-Day Letter		$50,737.48	
Less Adjustment—per schedule of Prorated Commissions		11,866.30	
		$38,871.18	
Less Dividends	$3,407.25		
Exemption	3,500.00	6,907.25	
Corrected Net Income		$31,963.93	

TAX COMPUTATION.

Net Income		$31,963.93	
@ 1½%		4,000.00	$ 60.00
		$27,963.93	

@ 3%		4,000.00	120.00
@ 5%		$23,963.93	1,198.19
Surtax:			
$36,000.00	$1,400.00		
2,871.18 @ 10%	287.12		1,687.12
			$3,065.31
Earned Income	$6,739.27		
Less Exemption	3,500.00		
	3,239.27		
@ 1½%	48.58		

25%.....	12.14	12.14
		3,053.17
Less Paid at Source.....		26.90
		3,026.27
Tax Previously Assessed.....		3,470.11
Refund Due.....		443.84

[191] COMPUTATION OF TAX FOR 1926.

Net Income—per 60-Day Letter....		$42,122.48	
Less Adjustment per Prorate Schedule.....		8,855.58	
		$33,266.90	

TAX COMPUTATION.

Corrected Net Income.....			$33,266.90
Less Dividends.....		$3,019.79	
Exemption.....	3,500.00	6,519.79	
		$26,747.11	
@ 1½%.....		4,000.00	$ 60.00
		$22,747.11	
@ 3%.....		4,000.00	120.00
@ 5%.....		$18,747.11	937.35

Surtax:		
$32,000.00	$1,040.00	
1,266.90	114.02	1,154.02
		$2,271.37
Earned Income	$6,142.12	
Less Exemption	3,500.00	
	$2,642.12	
@ 1½%	39.63	
25%	9.91	9.91
		$2,261.46
Less Tax at Source		30.28
		$2,231.18
Previously Assessed		2,600.92
Refund Due plus Interest		$ 369.74

(Testimony of Kenneth N. Logan.)

[192] WITNESS.—(Continuing.) These three papers headed, "Edward Brown & Sons. Prorate of overriding commissions" for various years, "including carry-over from January 1, 1918," are first a summary for the year, 1925, on exactly the same method of computation as in the previous summaries, except that in this case we have gone back to January 1, 1918, to pick up and include in the current year any accrual that might fall in that year on business written in prior years, from 1918. Exhibit No. 20 is made up in exactly the same way except for the years involved, and is for 1923, and goes back to 1918. These other papers which have not yet been marked have the same sort of computation for the years 1924, 1925 and 1926, and as to commission figures, the figures are taken from the books of Edward Brown & Sons, which are here in court.

Thereupon the documents referred to were offered and received in evidence as Petitioner's Exhibit No. 27, was so marked, and was and are as follows:

[1937]

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1, 1924 to December 31, 1924
including carry over from January 1, 1918

Balance from 1923 schedule	TOTAL	1924	1925	1926	1927	1928	1929
For Year 1924	$125,255.29	$125,255.29	$	$	$	$	$
1925	41,722.25		41,722.25				
1926	16,816.51			16,816.51			
1927	1,017.28				1,017.28		
1928	380.48					380.48	
Commissions on Policies written in 1924:							
On 1 year Policies	133,507.36	66,753.68	66,753.68				
3 year Policies	84,198.80	14,033.13	28,066.27	28,066.26	14,033.14		
5 year Policies	1,944.17	194.42	388.83	388.83	388.83	388.83	194.43
Special Commissions	1,211.98	1,211.98					
	$406,053.12	$207,448.50	$136,931.03	$ 45,270.60	$15,439.25	$ 769.31	$ 194.43
Less 1/6 to A.M.Brown, Jr.		34,574.75					
Corrected Earned Commission of A. M. Brown for 1924		$172,873.75					

Adjustment to Net Income:

Commissions 1924	$223,721.60	
Even Farm Profits	694.86	$224,416.46
Return Commission Dec. 31, 1923	$ 52,971.96	
" " Dec. 31, 1924	49,417.82	3,554.14
		$220,862.31
Less 1/6 to A. M. Brown, Jr.		36,810.38
		$184,051.93
Commission, per Agent Corrected, as above		172,873.75
		$ 11,178.18

EXHIBIT #27 (1)

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1 to December 31, 1925
Including carry over from January 1, 1918

	Totals	1925	1926	1927	1928	1929
Balances from 1924 Schedule						
For 1925	$136,931.03	$136,931.03	$		$	$
1926	45,270.60		45,270.60			
1927	15,439.25			15,439.25		
1928	769.31				769.31	
1929	194.43					194.43
	$198,604.62					
Commission on Business written in 1925 on -						
1 Year Policies	145,478.88	72,739.44	72,739.44			
3 " "	92,359.66	15,393.26	30,786.52	30,786.52	15,393.26	
5 " "	40.89	8.18	8.17	8.18	8.18	8.18
Special	1,430.63	1,430.63				
	$437,832.80	$226,486.18	$148,788.39	$ 46,217.69	$16,154.39	$ 186.25

First one-half year 1925	$113,243.09	
Less 1/6 to A.M.Brown, Jr.	18,873.85	94,369.24
Second one-half Year 1925	$113,243.09	
Less 1/4 to A.M.Brown, Jr.	28,310.77	84,932.32
Corrected Earned Commissions Arthur M. Brown in 1925		$179,301.56
Commissions 1925	$237,714.69	
Svea Farm Profit	1,779.49	$235,935.20
Return Commission Dec.31,1924	$ 49,417.82	
Return Commission Dec.31,1925	52,710.80	3,292.98
		$239,228.18
Less 5/24 to A. M. Brown, Jr.		49,839.22
		$189,388.96
Corrected, as above		179,301.56
Net adjustment to Agent's Net Income		$ 10,087.40

EXHIBIT #27 (2)

228
[1957]

EDWARD BROWN & SONS

Prorate of Overriding Commissions from January 1, 1926 to December 31, 1926
including carry over from January 1, 1918

	Totals		1926	1927	1928	1929
Balance from 1925 Schedule for 1926	$148,788.39		$148,788.39	$	$	$
1927	46,217.59			46,217.59		
1928	16,184.39				16,184.39	
1929	186.25					186.25
Commissions on Business Written in 1926						
on 1 year Policies	141,042.51		70,521.25	70,521.26		
" 3 " "	107,929.05		17,988.17	35,976.35	35,976.35	17,988.18
" 5 " "	477.08		119.27	119.27	119.27	119.27
Special Commissions	6,593.25		6,593.25			
	$466,434.35		$243,771.79	$152,595.93	$ 52,011.47	$ 18,055.16
Less- 1/4 to A. M. Brown, Jr.			60,942.95			
Corrected Earned Income Arthur M. Brown			$182,828.84			
Commissions 1926		$253,881.21				
Over Farm Profit		741.25	$253,139.96			
Return Commission Dec. 31, 1925		$ 52,710.80				
" " Dec. 31, 1926		54,658.57	1,947.77			
			$255,087.73			
Less 1/4 to A. M. Brown, Jr.			63,771.93			
Commissions, per Agent's Report			$191,315.80			
Corrected, as above			182,828.84			
Net Adjustment to Agent's Net Income			$ 8,486.96			

EXHIBIT #27 (3)

(Testimony of Kenneth N. Logan.)

[196] WITNESS. — (Continuing.) Exhibits No. 20 and No. 27 differ from Exhibits Nos. 21, 22, 23 and 24, in that the latter contemplate that the carry-over commences as of August 1, 1922, and prorates for earned commissions have been based on the carry-over for that period only. In Exhibits Nos. 20 and 27 we go back to 1918 to pick up any accruals that would fall in the year 1923 or subsequent years, and have taken the five year policies written in 1918. I have determined how much of the commissions with respect to those policies was unearned at the beginning of 1923 or subsequent years. On three-year business I have gone back to 1920 and picked up such part of the commission on business written in that year as was earned in 1923 or later. From 1918 I have included subsequent years on five year business, and on three year business from 1920 on. As to one year business I have included the proper proportion written in 1922 and prior to August 1, 1922, and have corrected the figures to take care of the participation of Herbert H. Brown in such parts of the commissions as were earned before his death, and have arrived at a net figure for Arthur M. Brown. For the years after 1923 I have followed the same method with respect to the interest of Arthur M. Brown, Jr., as already indicated on Exhibits Nos. 21, 22, 23 and 24. The only difference between Exhibits Nos. 20 and 27, upon the one hand, and Nos. 21, 22, 23 and 24, upon the other, is that in the former I have computed the

(Testimony of Kenneth N. Logan.)

[197] earned commission for the years in question on all policies in force during those years, but in Exhibits Nos. 21, 22, 23 and 24, I have assumed that it was only necessary to go back to the date of the death of Herbert H. Brown to pick up unearned carry-over for the subsequent years. I have a computation of the tax for these exhibits.

Thereupon the computation referred to was offered in evidence on behalf of the petitioner, and to such offer respondent objected.

EXCEPTION No. 5.

Said objection was sustained, and said offer rejected, to which said ruling petitioner then and there duly excepted, and now excepts, and assigns the same as error. The computations so offered and rejected was then marked for identification as Petitioner's Exhibit No. 28 for identification, and was and is as follows:

PETITIONER'S EXHIBIT No. 28.

[198] COMPUTATION OF TAX FOR YEAR 1923.

Total Income as adjusted per 60 day Letter		$97,290.56
Less:		
Adjustment for Earned Income		
Commission Income per agent	$236,693.31	
As adjusted by prorate	168,444.39	
	$ 68,248.92	
Adjustment for Edith H. Halton	3,000.00	65,248.92
Corrected Total Income		$32,041.64
Less: Dividend	$4,479.20	
Exemption	2,000.00	6,479.20

Amount subject to Normal Tax.....		$25,562,44
Tax.....	$25,562.44	
@ 4%.....	4,000.00	160.00
@ 8%.....	$21,562.44	1,725.00
Surtax.....		1,706.25
		$3,591.25
Less: 25% reduction.....		
Revenue Act 1924.....		922.81
		$2,668.44
Tax Originally Assessed.....	$4,401.20	
Less: 25% reduction.....		
Revenue Act 1924.....	1,100.30	3,300.90
Refund Due and Interest.....		$ 632.46

[199] COMPUTATION OF TAX FOR YEAR 1925.

Net Income per 60-Day Letter		$50,737.48
Less Adjustment—per Schedule of Prorated Commissions		10,087.40
Corrected Net Income		$40,650.08

TAX COMPUTATION.

Net Income		$40,650.08
Less Dividends	$3,407.25	
Exemptions	3,500.00	6,907.25
Subject to Normal Tax		$33,742.83

@ 1½%		4,000.00	$ 60.00
		$29,742.83	
@ 3%		4,000.00	120.00
@ 5%		$25,742.83	1,287.14
Surtax:			
$40,000.00	$1,800.00		
650.08 @ 11%	71.51		1,871.51
			3,338.65
Earned Income	$6,774.85		

Less Personal Exemption.....	3,500.00	
	$3,274.85	
Tax @ 1½%.....	49.11	
25%.....	12.28	12.28
		3,326.37
Less Tax Paid at Source.....		26.90
		3,299.47
Tax Previously Assessed.....		3,470.11
Refund due and Interest.....		170.64

[200] COMPUTATION OF TAX FOR YEAR

1926.

Net Income per 60-day letter.....		$42,122.48
Less Adjustment per Prorate Schedule...		8,486.96
Adjusted Net Income.....		$33,635.52

TAX COMPUTATION.

Net Income.....		$33,635.52
Less—Dividends.....	$3,019.79	
Exemption.....	3,500.00	6,519.79
		$27,115.73

@ 1½%		4,000.00	60.00
		$23,115.73	
3%		4,000.00	120.00
		$19,115.73	
5%			955.78
Surtax:			
$32,000.00	$1,040.00		
1,635.52 @ 9%	147.20		1,187.20
			$2,322.98

Earned Income Credit	$6,215.85	
Less Exemption	3,500.00	
	2,715.85	
@ 1½%	40.74	
25%	10.18	10.18
		$2,312.80
Less Tax Paid at Source		30.28
		$2,282.52
Tax Previously Assessed		$2,600.92
Refund Due plus Interest		$ 318.40

(Testimony of Kenneth N. Logan.)

[201] WITNESS.—(Continuing.) This paper headed "Edward Brown & Sons. Basis for establishing cancellation liability December 31, 1922," is a computation adjustment made on the same basis as that made on the books of Edward Brown & Sons, December 31, 1923, settling up a liability for cancellations that would take effect in subsequent years on business written and in force during 1922. In other words, it gives the balance at the beginning of the year, 1923, on the same basis as the closing balance for similar liability at the end of the 1923. I have arrived at the figure from past experience of the ratio of cancellations to business written. I got the figures from the books of Edward Brown & Sons, and the ratio of cancellation to business written was 23.06%. I then computed the amount of cancellations likely to occur with respect to business written in 1922, using that ratio and setting up figures which would take care of cancellations that would occur in 1923 and later years on business written in 1922. The books of Edward Brown & Sons show the net commissions during the year, and show a deduction by way of a figure to take care of cancellations and necessary return commission. If that was what the books would show that would amount to a double deduction because my figures for commission during 1923 was the net figure—it is the gross premiums less return premiums, less reinsurance, plus reinsurance cancellation, known in insurance terms as net premiums. The computation [202] is made to set up a figure which past experi-

(Testimony of Kenneth N. Logan.)

ence has shown will be a liability to Edward Brown & Sons to return commissions on business cancelled in subsequent years. This computation is for the purpose of avoiding any double deduction. This last exhibit represents figures taken off the books, and these are calculations from those figures on the basis I have just explained.

Thereupon the document referred to was offered and received in evidence, was marked Petitioner's Exhibit No. 29, and was and is as follows:

PETITIONER'S EXHIBIT No. 29.

[203] EDWARD BROWN & SONS.

Basis for
Establishing Cancellation Liability December 31, 1922,
Arthur M. Brown's Interest
in Total Commissions Written 1922.

Basis for Return Commission Liability for year 1922 on similar basis as used in 1923:

	Fire Premiums	Fire Cancellations
1918	$2,275,515	$480.616
1919	2,755,436	643,409
1920	3,383,810	814,200
1921	2,714,243	678,669
1922	2,702,822	572,894
	13,831,726	3,189,788

Ratio.	23.06%	
Total Fire Overriding Commissions for 1922		182,033.92
7/12 written during Partnership	106,186.43	
Herbert H. Brown's Interest 40%		42,474.57
		139,559.35
23.06% for Cancellations		32,182.39
Allowance carried forward December 31, 1922		32,182.39
Overriding Commissions 1923		236,693.31
		268,875.70
Less—Allowance for Cancellations December 31, 1923		52,971.96
Corrected		215,903.74

Originally Reported	236,693.31	
Less Allowance	52,971.96	
		183,721.35
		32,182.39
Agent		236,693.31
As above		215,903.74
		20,789.57

(Testimony of Kenneth N. Logan.)

[204] WITNESS.—(Continuing.) This (referring to paper) is a similar computation for the purpose of computing what the cancellation set up should be on commissions carried over to subsequent years, going back to August 1, 1922, on the same basis and for the same purpose as the last exhibit.

Thereupon the document referred to was offered and received in evidence as Petitioner's Exhibit No. 30, was so marked and was and is as follows:

PETITIONER'S EXHIBIT No. 30.

[205] EDWARD BROWN & SONS.

Basis for
Establishing Cancellation Liability December 31, 1922.

Arthur M. Brown's Interest
from August 1, 1922 to December 31, 1922.

Ratio of premiums to Cancellations for Years 1918–1922 (see other schedule)		23.06%
Commissions written 1922	182,033.92	
7/12 written during Partnership	106,186.43	
		75,847.49
23.06% for Cancellations to 1923		17,490.43
Overriding Commission 1923	236,693.31	
		254,183.74

(Testimony of Kenneth N. Logan.)

Less Allowance for Cancellations carried to 1924	52,971.96
	201,211.78
Agent's Report	236,693.31
	35,481.53

[206] These last exhibits do not take into account prorating the income on any premium basis or any commission basis related to premiums on the basis of the time in which they are earned. Exhibits 20 to 27, inclusive, are on an actual basis, taking the actual figures of commissions as shown on the books, and prorating them for the years in which they were earned. These last figures, taking the net commissions for any one year, as shown on the books, and with proper adjustments at the beginning and end of the year, set up a figure which the experience of the books shows is likely to be the cancellations from those commissions in future years. It does not attempt to prorate the income for the actual periods in which it was earned. The purpose is simply to produce a figure, which will be the ultimate earnings if the past experience holds true with Edward Brown & Sons' commissions written for the particular year. I have the computation of the journal entry made in December, 1923, setting up the liability. This is a copy. The original is here in court.

Thereupon the original journal entry was pro-

(Testimony of Kenneth N. Logan.)

duced and exhibited to counsel for respondent, and the copy was offered and received in evidence as Petitioner's Exhibit No. 31, was so marked, and was and is as follows:

PETITIONER'S EXHIBIT No. 31.

[207] "A. Commission Overriding $52,971.96

A. To return Commission $52,971.96

	Fire Prems.	Fire Canc.
1919	2,755,436	643,409
1920	3,383,810	814,200
1921	2,714,243	687,669
1922	2,702,822	572,894
1923	3,336,711	623,932
	14,893,022	3,333,104

Ratio 22.38.

Total Fire Aver. Comm. for 1923—$236,693.31."

A photostatic copy of the page of the journal containing the foregoing entry was subsequently offered and received in evidence as part of Petitioner's Exhibit No. 32, and it is prayed that the original exhibit, to wit, the said photastatic copy, be forwarded to the Circuit Court of Appeals for the Ninth Circuit with the transcript herein, and as part of the record on appeal.

WITNESS.—(Continuing.) The books of Edward Brown & Sons for the year, 1923, show a figure for commissions earned, less this figure computed on

(Testimony of Kenneth N. Logan.)

the basis of experience. That figure represents the difference between the return made by Arthur M. Brown, as corrected for all deductions, and the basis upon which the deficiency was assessed by the Commissioner, with the exception of the Halton matter and the item of credits between the taxpayer and the Department. With the exception of the $3,000 in the [208] Halton matter the total difference between the basis of computing the deficiency by the Commissioner and the taxpayer is represented by that one figure. Similar figures were set up for 1924, 1925 and 1926. Those figures were set up when there was a carry-over at the beginning of each of those years from the figure set up at the end of the preceding year, and cancellations during those years were charged back against the figures set up for the beginning of the year, so that after 1923 the only figure in difference between the taxpayer and the respondent is, not the total of the figure set up, but the difference between the figure at the beginning of the year and at the end of the year—that is, the net adjustment to that account. Those figures are included in that reconciliation of the books to the agent's report in 1924, 1925 and 1926, 1923 being the full liability figures. Exhibit No. 29 refers only to 1923. These net adjustments we have just been speaking about and their computations are shown on Exhibit No. 25. On the basis of Exhibits 20 and 27—on the accrual basis of prorating commissions for the year in which earned, and going back and picking up the five year busi-

(Testimony of Kenneth N. Logan.)

ness in 1918, the three year business from 1920, and the one year business for the whole of 1922, the figures showing the unearned commissions at the beginning of 1923 appear on Exhibit 20, and the total is $80,204.22. That figure was arrived at by taking the carry-over at the beginning of the year, 1922, and falling in 1923—that is, by taking business written in the years, 1918 to 1922, which [209] was earned in 1923, as shown by the column "1923" on Exhibit 20. The total of that column is $168,444, of which $80,204.22 is carried over from previous years, and $88,240.17 is for the current year, 1923. The method of computing that is simply taking in the first column which shows the year in which the policy was written. If that is a date prior to the current year date, then that figure is the one to be used in the year in which the carry-over is desired.

Q. That would be the same as the commission for those respective years on Exhibits 21, 22, 23 and 24; that figure will not change, will it? A. No.

The unearned commission at the end of 1923 is $185,190.81.

Thereupon there was produced and identified journal entries from the journal of Edward Brown & Sons for December, 1924, December, 1925, and December, 1926, and by stipulation photostatic copies were substituted for the originals and were offered and received in evidence, together with a photostatic copy of the journal entry for December, 1923, as Petitioner's Exhibit No. 32, and the same was so marked. It is prayed that the original of said exhibit, to wit, said photostatic copies, be forwarded

to the Circuit Court of Appeals for the Ninth Circuit with the transcript herein and as part of the record on appeal. Said entries so far as germane to the matters in issue here were and are as follows:

PETITIONER'S EXHIBIT No. 32.

[210] DECEMBER, 1924.

" * * *

A. Commission Overriding 49,417.82

A. To Return Comm. 49,417.82

	Fire Prems.	Fire Canc.
1920	3,383,810	814,200
1921	2,714,243	678,669
1922	2,702,822	572,894
1923	3,336,711	623,932
1924	3,509,896	802,406
	15,647,482	3,492,101

Ratio 22.32.

Total Fire Over. Comm. for 1924 $221,406.02."

DECEMBER, 1925.

" * * *

A. Commission Overriding 52,710.80

A. To Return Comm. 52,710.80

	Fire Prems.	Fire Canc.
1921	2,714,243	678,669
1922	2,702,822	572,894
1923	3,336,711	623,932

(Testimony of Kenneth N. Logan.)

1924	3,509,896	802,406
1925	3,667,771	754,769
	15,931,443	3,432,670

Ratio 21.55.

Total Fire Overriding Comm. for 1925—$244,-597.68."

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[211] DECEMBER, 1926.

" * * *

A. Commission Overriding	54,658.57	
A. To Return Comm.		54,658.57

	Fire Premiums.	Fire Canc.
1922	2,702,822	572,894
1923	3,336,711	623,932
1924	3,509,896	802,406
1925	3,667,771	754,769
1926	3,938,159	870,070
	17,155,359	3,624,071

Ratio 21.13.

Total Fire Overriding Comm. for 1926—$258,-677.57."

WITNESS.—(Continuing.) The figures from which the ratio was computed were taken from the books of Edward Brown & Sons and show their experience. The figures on which my computations have been based are the figures which I have taken from the books of Edward Brown & Sons, and the

(Testimony of Kenneth N. Logan.)

additional figures which appear as my computations are simply mathematical computations made by me from those figures. In order to make the mathematical computations it was not necessary to go back and set up the books in any different way. The system of the books kept by Edward Brown & Sons as a whole is on the accrual method, which is the accepted [212] basis for computing income of a general agent.

Cross-examination by Mr. MEACHAM.

I have been acquainted with the books and records and accounts of Edward Brown & Sons since 1924. Our firm has handled accounts for Arthur M. Brown prior to that time, but I personally did not. Our first work during 1924 was on the accounts for 1920. I was in Edward Brown & Sons office during 1924 probably a half dozen times spread out over the year, for replies to certain revenue department examinations of income tax. It was activity of Government agents which resulted in my employment. We had no supervision of the books. We examined them for certain specific things. We do not construct the books ourselves. Frequently certified public accountants supervise the entire bookkeeping system and prepare and file returns, but that was not our employment with the petitioner in this case. The books of Edward Brown & Sons during the taxable years in question were kept on the theory which I arrived at in 1927. I would say that the returns filed by the petitioner for the years involved

(Testimony of Kenneth N. Logan.)

were not filed in accordance with this theory. If the Board should decide that our theory in reference to prorating earned commissions was proper the returns would have to be amended. I have never personally made any entries in the books of petitioner, nor directly or indirectly suggested any changes, corrections, alterations or erasures in the books for the years as to which I directed my testimony. Partnership and corporations [213] are two different entities. The theory of accounting would not differ as to them though the application of it to the particular problem might. The method which I referred to this morning of reporting income for a period over five years would require an extension beyond the time during which the partnership might exist, or a proper consideration could be taken at the time that the partnership ceases. We would not have to guess or apply experience tables to find the unearned portion of the commission, but could do it by accrual computation of the unearned premium. That does not include any experience tables. I have been over the books, records, ledgers and documents as to which I have testified, as to all matters pertinent to the issues here, and I have had assistance under my supervision. I myself noticed a change in the item setting up the journal entry for the liability of cancellation for December 31, 1923. That change had been made the first time I saw the entry, and on inquiry found that they put the wrong item—I believe a credit item—on the wrong line and erased

(Testimony of Kenneth N. Logan.)

it. The typewritten copy does not show the change. I was informed that before the change the words "Commission Overriding" were where the words "Return Commissions" now are. If you search through the books you might find a good many other changes. I believe that that entry is in the handwriting of a Mrs. or Miss Anderson, who is now living and employed by the petitioner. I don't know when the change was made.

Mr. DUNNE.—Would you like to have her out here, Counsel?

[214] Mr. MEACHAM.—Well, unless I can satisfy myself, for the purpose of the record as to the change, it may be necessary to get her here to find out what—

The WITNESS.—The change was made at the time—prior to the time that the revenue agent came in, because he shows the same entry in his return.

WITNESS.—(Continuing.) The agent's report is dated May 6th, 1927, and he came in some time before then. The entry you will find posted in the books to the same account. They did not prorate the commissions on the books. In my opinion no change in the basis of the filing of the returns or the basis of accounting was necessary. I have my personal fee in this case but no other financial interest in its outcome. Edward Brown & Sons have in addition to commission income, income from a percentage of the profits made by the insurance company on the business written in the territory

(Testimony of Kenneth N. Logan.)

of Edward Brown & Sons. That is not commission. The income from the commissions has been computed on what is known in the insurance world as the net premiums—the net business written for a year. The income tax return was not made in accordance with that, but on the basis of net commissions on premiums less allowance for cancellations in future years. The returns are in accordance with the books and on the same basis that the books have kept on. During 1923 when the figure of $52,971.96 was set up, it was set up not as a reserve but as an established liability for return commissions which would have to be repaid to the insurance companies [215] upon cancellation. This type would not be called a reserve. I call it a liability, to establish on the books a figure to be returned to the insurance companies on the cancellation of policies which would effect a return of commission. During 1923 we also deducted the amount actually returned during that year. We had this figure for the purpose of deducting that amount returned to insurance companies in later years. We did not have a double check on that return commission because the cancellation against which this liability is established had not, at that point, been made. The cancellation is to take effect in later years. That was set up in December, 1923, for the first time. We did not know the exact amount until it was actually paid out. This amount of $52,971.96 seemed adequate from the experience of the past five years. It might have been 2/3*ds* of

(Testimony of Kenneth N. Logan.)

that if the current year differed from the previous years. The amount to be deducted depends on the amount of the commissions returned. If that was $25,000 the liability figure would have that much deducted from it. There is a contingency there—you cannot foresee actually as to the definite amounts. It is a contingent liability based on the experience of the five years preceding. Some commission income is deferred on the books of Edward Brown & Sons to later years through the medium of this liability set up on the books, but aside from that all commissions are included in profit and loss during the year when the business is written. On Exhibit No. 25 we have 1924, 1925 [216] and 1926, but not 1923, because that year did not have a return commission account, and the only figure deducted from overriding commission is the $52,971.96 set up at the end of 1923 for carry-over of commissions. The total gross income from commissions is composed of commissions on policies written during the year, less a liability established at the end of the year for anticipated cancellation in subsequent years, plus the liability established at the beginning of the year for cancellations to take effect in that and subsequent years. That is without regard to the length of the policy. In some years Arthur M. Brown, Jr., was a partner. The status of Mrs. Halton has already been explained. The entry to the children of Herbert H. Brown is a charge to Arthur M. Brown and undeductible. In 1923 there were no partners and only

(Testimony of Kenneth N. Logan.)

an individual return was filed. In 1925 and 1926 there were two partners, Mr. Brown and his son, and Mrs. Halton, a sort of limited partner, having an interest to the extent of a specified amount. She had no interest other than the receipt of $3,000 a year. When policies are short rated that is in favor of the company because the company receives a larger proportion of the premium during the time the policy was in force than it would have for the same period had the insurance been permitted to continue. If the policy has run half its length, and the assured cancels, the company gets more than half the total premium. That does not apply to cancellations by the insurance companies —there they return the full *pro rata* of the premium. Edward Brown & Sons [217] are general agents, and their income is partly from commissions. They do not receive premiums. An insurance company receives premiums, and the agent receives commissions.

Redirect Examination by Mr. DUNNE.

It was stipulated as to the journal entry for December 31, 1923 (Petitioner's Exhibit No. 31 and the 1923 sheet of Petitioner's Exhibit No. 32), had not been changed as to any figure as distinguished from a letter in a word, and that the only change was in a heading; that the first line reads "Commission Overriding" with the figure $52,971.96, and the next line starts with "To" that has not been changed, and that as to the next two

(Testimony of Kenneth N. Logan.)

words "Return Commissions" there has been an erasure, and that there was no other change.

WITNESS.—(Continuing.) With reference to whether or not permission was ever asked to change the basis of making the return, I will say that no change has been made in the method of keeping the books of account, and they were kept for that year, 1923, and following, in the same manner as they were kept for the preceding years back to 1918—that is, the accrual method. The fee which I will get for services here will not in any way be affected by the outcome of this case—it is not contingent. With regard to the contingent profit account of Edward Brown & Sons no earnings resulting therefrom and from participation in the profits of their companies have in any form entered into any figure we are using. We are [218] dealing simply with the overriding commission—the commission that is earned over the life of the policy. In speaking of contingent liability for return commissions the only thing that I mean was contingent was the exact amount. After the years in question there have been calculations, and those calculations very closely approximated the figure arrived at by using this ratio, but I have not computed the exact amount.

Thereupon petitioner rested, and respondent having no evidence to offer likewise rested.

Thereupon petitioner moved for judgment that the items in issue were proper deductions, and that as to the matter of commissions petitioner be

permitted first to return his income for the years in question on the accrual basis, *pro rata* basis, returning in each year only the overriding commission earned in that year, carrying into those computations for commissions earned in 1923, and subsequent years, only the unearned part of the commissions on business written from August 1st, 1922, and following, after the death of Herbert H. Brown, or if that is denied then on the same basis but including actual carry-over of unearned commission into the years in question from the inception of any policies in force during those years, or if that is denied, that petitioner be permitted to return his tax for the years in question [219] by showing his income for those years and setting up as against it a figure representing the liability included and connected with those commissions, to return the proportionate commission in future years that will correspond with the unearned part of the premium in the event of cancellation of the policy, in other words, upon the basis upon which the returns were actually made but with proper connection for reserves at the beginning of the tax years.

EXCEPTION No. 6.

The matter was thereupon submitted and briefs filed by both parties, and the said motion was denied, and findings and judgment made, promulgated and entered in favor of respondent, as more fully appears from the findings, opinion and judgments herein, to which said ruling and to which

findings, opinion and judgments, petitioner duly excepted and now excepts and assigns the same as error.

The foregoing is a full, true and correct, concise statement of all of the evidence in the above-entitled matters, and contains all of the evidence offered or introduced on the trial of the above matters and all proceedings on the trial of the above matters, and except as to the pleadings, there was no matter, happening or showing before the Honorable, The United States Board of Tax Appeals [220] in making its determinations in the above-entitled matters, except as herein set out.

And now, agreeable to the provisions of law and the rules of the Honorable, the United States Circuit Court of Appeals for the Ninth Circuit, in such cases made and provided, and within the time allowed by law and by the rules of said court and orders of said court made herein, petitioner presents and lodges the foregoing statement of the evidence for examination by respondent and approval by the Honorable, the United States Board of Tax Appeals; and

Petitioner prays that all of the exhibits herein be deemed a part of the foregoing statement of the evidence and be, by the Clerk of the United States Board of Tax Appeals, attached to the transcript of record on appeal and review, and as such be forwarded to the Circuit Court of Appeals of the United States, for the Ninth Circuit, and that the foregoing statement of evidence be allowed, settled and approved

as such, and for all purposes for which a statement of evidence may be used, to the end that the foregoing matters may be made matter of record.

Dated at San Francisco, California, December 11th, 1931.

ARTHUR B. DUNNE,
Attorney for Petitioner.
KENNETH N. LOGAN,
Accountant for Petitioner.

[221] STIPULATION AS TO SETTLEMENT OF STATEMENT OF EVIDENCE.

IT IS STIPULATED by the parties hereto that all of the exhibits offered in evidence on the trial of the above-entitled matters, including those offered and not received in evidence, but marked for identification, be considered a part of the foregoing statement of evidence, attached to the transcript of record on appeal and review, and with said transcript and the foregoing statement of evidence, be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit, and that the United States Board of Tax Appeals may make its order accordingly and it is further stipulated that the foregoing is a full, true and correct statement of all of the evidence offered, and offered and received, as therein appears, and a correct statement of all of the proceedings had on the trial of the above-entitled matters, and that there was no matter, happening or showing before the said United States Board of Tax Appeals, other than the pleadings, except as

therein shown, and that the same may be settled, approved and allowed, and the prayer thereof granted.

Dated at San Francisco, California, December 11th, 1931.

ARTHUR B. DUNNE,
Attorney for Petitioner.

[222] KENNETH N. LOGAN,
Accountant for Petitioner.

Dated at Washington, D. C., ————, 193—.

————————,
General Counsel, Bureau of Internal Revenue.

ORDER SETTLING STATEMENT OF EVIDENCE.

I, John J. Marquette, certify that I am a member of the United States Board of Tax Appeals, and the member before whom the above-entitled matters were tried, and the member who made the findings of fact and promulgated the opinion therein, and that all of the proceedings recited in the foregoing statement of evidence were had before me; that the foregoing statement was served and lodged herein, and settled and allowed, within the time allowed by law, and the rules of the United States Circuit Court of Appeals for the Ninth Circuit, as extended by orders of the United States Circuit Court of Appeals for the Ninth Circuit, [223] and, accordingly,

IT IS HEREBY ORDERED, that the prayer of said statement be, and the same is, hereby granted, and the foregoing stipulation thereto be, and the same is, hereby approved, and it is hereby ordered

accordingly, and it is further ordered that all of the exhibits in the above-entitled matters, including those offered and not received in evidence, but marked for identification, be considered a part of the foregoing statement of evidence, attached to the transcript of record on appeal and review, and be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit, with said transcript, and it is further ordered and adjudged, that the foregoing is a full, true and correct statement of all of the evidence offered, and offered and received, as therein appears, and a correct statement of all of the proceedings had on the trial of the above-entitled matters, and that there was no matter, happening or showing before the United States Board of Tax Appeals, other than the pleadings, except as therein shown, and that the same be, and it is, hereby approved, settled and allowed, and be filed and be made a part of the record herein and transmitted to the United States Circuit Court of Appeals for the Ninth Circuit, accordingly.

Dated January 21st, 1932.

JOHN J. MARQUETTE,
Member, United States Board of Tax Appeals.

[402] Filed Jan. 6, 1932.

United States Board of Tax Appeals.

Three proceedings entitled as here, and numbered respectively as follows:

DOCKET No. 35,305.

DOCKET No. 39,157.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PRAECIPE FOR PREPARATION OF TRANSCRIPT OF RECORD ON APPEAL.

To the United States Board of Tax Appeals, and to the Clerk Thereof:

You are requested to make up a transcript in the above-entitled matters, to be forwarded to the United States Circuit Court of Appeals for the Ninth Circuit, for use on petitioner's petition for review of the decisions of the United States Board of Tax Appeals in the above-entitled matters, and you are requested to include in said transcript and to duly certify as correct and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, at the Post Office Building, 7th and Mission Streets, San Francisco, California, copies of the following documents:

[403] 1. The docket entries in all of said causes of proceedings before the United States Board of Tax Appeals.

2. The pleadings in all of said causes before the United States Board of Tax Appeals.

3. The findings of fact, opinion and decisions of the United States Board of Tax Appeals.

4. Petitions for review filed by petitioner above named, in each of said matters.

5. Notices of filing of petitions for review.

6. When the same shall have been settled, allowed and approved and allowed, the consolidated statement of evidence settled or agreed upon in the above-entitled matters.

7. Stipulation and order in each of the above matters, for consolidation of the same on appeal.

8. Copies of all orders enlarging the time of petitioner for preparation, approval and filing of his statement of evidence, and for the preparation and transmission of the transcript herein and for the docketing of the cause in the United States Circuit Court of Appeals for the Ninth Circuit, not included in record.

9. All exhibits offered and received in evidence or marked for identification. (Exs. 3, 4 to 8, inc., 14, 20 to 31, inc., included in statement of evidence.)

10. This praecipe.

11. Affidavit of A. B. Dunne proving service.

Dated: December 31st, 1931.

ARTHUR B. DUNNE,
Attorney for Petitioner,
920 Insurance Exchange Building,
San Francisco, California.
KENNETH N. LOGAN,
Accountant for Petitioner,
Balfour Building, San Francisco,
California.

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[404] Filed Jan. 6, 1932.

United States Board of Tax Appeals.

Three proceedings entitled as here, and numbered respectively as follows:

DOCKET No. 35,305.

DOCKET No. 39,157.

DOCKET No. 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

AFFIDAVIT OF ARTHUR B. DUNNE AS TO SERVICE OF PAPERS.

Arthur B. Dunne, being first duly sworn, deposes and says:

That he served upon respondent above named by service on the attorney for respondent, the papers hereinafter specified, and served the same by mail,

the same being mailed on the dates hereinafter specified; that each of said papers was served by enclosing the same in a sealed envelope, addressed "C. M. Charest, Esq., General Counsel, Bureau of Internal Revenue, Treasury Department, Washington, D. C.," and posting the same, so addressed and sealed, with postage thereon prepaid, in the United States mail in the City and County of San Francisco, State of California, on the dates hereinafter specified; that there is a regular [405] United States mail service between said City and County of San Francisco and the point to which said envelopes were addressed as aforesaid; that the papers hereinbefore referred to, and the dates upon which the same were mailed, were and are as follows:

Petitioner's proposed consolidated statement of evidence, mailed December 12th, 1931;

Order of the United States Circuit Court of Appeals for the Ninth Circuit, dated November 2d, 1931, enlarging petitioner's time for steps with respect to petition for review, mailed November 2d, 1931; like order of said court, dated December 1st, 1931, mailed December 1st, 1931;

Notice of lodgment of consolidated statement of evidence, and time and place of presentation of same;

Request to present same for approval;

Praecipe for preparation of transcript on appeal, said last three papers having been mailed on the 2d day of January, 1932.

ARTHUR B. DUNNE.

Subscribed and sworn to before me this 2 day of January, 1932.

[Notarial Seal] KATHRYN E. STONE,
Notary Public in and for the City and County of San Francisco, State of California.

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[406] DOCKET Nos. 35,305, 39,157, 43,432.

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CERTIFICATE OF CLERK U. S. BOARD OF TAX APPEALS TO TRANSCRIPT OF RECORD.

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 405, inclusive, contain and are a true copy of the transcript of record, papers and proceedings on file and of record in my office as called for by the praecipe in the appeal (or appeals) as above numbered and entitled.

IN TESTIMONY WHEREOF, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 21 day of March, A. D. 1932.

[Seal] B. D. GAMBLE,
Clerk.

[Endorsed]: No. 6812. United States Circuit Court of Appeals for the Ninth Circuit. Arthur M. Brown, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Arthur M. Brown Petitioner, vs. Commissioner of Internal Revenue, Respondent. Arthur M. Brown, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of Record. Upon Petitions to Review Orders of the United States Board of Tax Appeals.

Filed April 9, 1932.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals for the Ninth Circuit.

No. 6812.

ARTHUR M. BROWN,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

STIPULATION AND ORDER RE PRINTING OF TRANSCRIPT.

The appellant in the above-entitled matter, having presented and filed in this court its transcript of record in the above-entitled matter; and

It appearing that there is certain matter in said transcript that it is unnecessary to reproduce in the printed transcript of record,—

IT IS STIPULATED that the transcript filed in the above-entitled court shall be printed in full except the photostatic copies of the exhibits, being the exhibits which are not set out in appellant's statement of evidence; and

IT IS FURTHER STIPULATED that any of the matter appearing in the said exhibits not to be reproduced in the printed record may be referred to and relied upon by counsel if set out and reproduced in the briefs.

Dated: May 10, 1932.

ARTHUR B. DUNNE,
Attorney for Appellant.
C. M. CHAREST,
Attorney for Commissioner of Internal Revenue.

So ordered.

Dated: ——————————, 1932.

CURTIS D. WILBUR,
Circuit Judge.

[Endorsed]: Filed May 10, 1932. Paul P. O'Brien, Clerk.

In the United States Circuit Court of Appeals for the Ninth Circuit.

No. 6812.

ARTHUR M. BROWN,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

PRAECIPE FOR PRINTING TRANSCRIPT OF RECORD.

To the Clerk of the Above-entitled Court:

The appellant respectfully requests that the transcript of record now on file in the above-entitled matter be printed in accordance with the stipulation of counsel handed you contemporaneously herewith, together with the order of court thereof.

Dated: May 10th, 1932.

ARTHUR B. DUNNE,
Attorney for Appellant.

[Endorsed]: Filed May 10, 1932. Paul P. O'Brien, Clerk.

No. 6812

United States
Circuit Court of Appeals
For the Ninth Circuit

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Upon Petitions to Review Orders of the United States Board of Tax Appeals.

PROCEEDINGS HAD IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

At a stated term, to wit, the October Term, A. D. 1932, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the Court Room thereof, in the City and County of San Francisco, in the State of California, on Monday the twenty-first day of November in the year of our Lord One Thousand Nine Hundred and Thirty-two.

Present: The Honorable CURTIS D. WILBUR, Senior Circuit Judge, Presiding, Honorable WILLIAM H. SAWTELLE, Circuit Judge, Honorable CHARLES C. CAVANAH, District Judge.

[Title of Cause.]

ORDER OF SUBMISSION.

ORDERED petitions to review in above cause argued by Mr. Arthur B. Dunne, counsel for the petitioner, and by Mr. Wm. Cutler Thompson, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

At a stated term, to wit, the October Term, A. D. 1932, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the Court Room thereof, in the City and County of San Francisco, in the State of California, on Monday the sixth day of February in the year of our Lord One Thousand Nine Hundred and Thirty-three.

Present: The Honorable CURTIS D. WILBUR, Senior Circuit Judge, Presiding, Honorable WILLIAM H. SAWTELLE, Circuit Judge, Honorable JULIAN W. MACK, Circuit Judge.

[Title of Cause.]

ORDER DIRECTING FILING OF OPINION AND FILING AND RECORDING OF JUDGMENT.

By direction of the court, ORDERED that the typewritten opinion this day rendered by this court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion filed.

[Tile of Court and Cause.]

OPINION OF UNITED STATES CIRCUIT COURT OF APPEALS.

Upon Petitions to Review Orders of the United States Board of Tax Appeals.

Before: WILBUR and SAWTELLE, Circuit Judges, and CAVANAH, District Judge.

CAVANAH, District Judge:

These are three appeals from a decision of the Board of Tax Appeals denying the petitioner a redetermination of alleged deficiencies in his income taxes for the year 1923, 1925, and 1926, in the

respective sums of $17,923.03, $1520.19, and $944.30. The cases were consolidated for hearing and decision before the Board, and are so presented here on a single transcript of record.

The tax involved is the individual, normal income tax and surtax of the petitioner, Arthur M. Brown, for the years thus stated. In 1923 the petitioner was conducting, alone, the business of a general insurance agent, and during the taxable years 1925 and 1926, it was carred on by a partnership composed of him and his son, Arthur M. Brown, Jr., under the name of Edward Brown & Sons.

On June 1, 1902, Edward Brown, Herbert H. Brown, and the petitioner executed a written agreement, by the terms of which they declared their respective interests in the business and then provided:

> "Before any decision of profits is made the said partners mutually agree to pay monthly to Jessie H. Jones, Edith H. Halton, and Ethel Brown (the three daughters of Edward Brown and Sisters of Arthur M. Brown and Herbert H. Brown) the sum of Two Hundred and Fifty Dollars (250) and, Further, that whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand Dollars per annum they will pay a one-sixth proportion of such excess to the said Jessie H. Jones, Edith H. Halton, and Ethel Brown."

On May 28, 1907, Edith H. Halton and Ethel Crandell, the two surviving sisters, executed a writ-

ten agreement in which they agreed to accept from the firm $250.00 per month, beginning June 1, 1907, and ending only by mutual agreement, "in full satisfaction of all amounts which may be due, or may become due, to us, or either of us, or to the survivor of us", under the agreement of May 27, 1905, which provides:

> "That any further amounts to which we, or either of us, or the survivor of us, might be entitled from said firm under said agreement shall be retained in the net profits of said firm as the property and to the credit of said Arthur M. Brown and Herbert H. Brown, members of said firm, to be divided between them as they may agree."

In 1923 the petitioner made a payment of $3000.00 to his sister, Edith H. Halton, in accordance with the agreement, and claimed the same as a deduction from business income in his tax return for that year. The deduction was disallowed by the Commissioner on the ground that the payment constituted a capital expenditure.

The surviving daughters of Edward Brown, of whom Edith H. Halton is one, having in the agreement of May 28, 1907, agreed to accept $250.00 per month in satisfaction of all amounts which may become due to them from the firm under the agreement of May 27, 1905, the terms of which are not in the record, and for that reason we are unable to determine what interest, if any, Edith H. Halton had in the business of Edward Brown & Sons, as a partner, or rendered at any time any ser-

vice to petitioner or the firm which would authorize the allowance of the item as a deductible business expenditure within the contemplation of the taxing statute.

The second issue is whether the Board of Tax Appeals adopted the proper method of treating the overriding commissions received by the firm of Edward Brown & Sons during the taxable years in dispute, where it held that petitioner, accounting on the accrual basis, was obliged to report the full amount of the overriding commissions received in the three years in controversy, without deducting, either as a reserve or otherwise, on account of a contingent liability to refund certain portions of such commissions in later years on account of reinsurance or cancellation.

This method adopted by the Board is challenged by petitioner, who asserts that he should be permitted to pay his tax on the basis of earned income computed under the actuarial computation. In other words, that there should be returned as income upon the basis of a *pro rata* apportionment of such commissions to the policy years.

The firm of Edward Brown & Sons acted as general agents for six fire insurance companies during the taxable years in controversy, and the duties required of it were the appointment and removal of local agents; issue, countersign, and cancel policies; adjust losses under policies, receive and receipt for premiums; compute and return premiums on cancelled policies; secure return of premiums on can-

celled reinsurance; receive and acknowledge service of proof of loss; accept service of process; survey all risks offered and accept or reject the same; transfer insurance by endorsement; attend to the payment of all taxes and license fees; and, generally attend to all of the affairs of its principals in the territory in which it operated. All of the policies written by the firm since 1917 are for periods of one, three, or five years, and are subject to cancellation by either the insurance company or the assured. If a policy is cancelled by the insurance company it is obligated to refund a ratable proportion of the premium for the unexpired term of the policy. In the event the assured cancels, the company is entitled to retain the customary short period rate for the time the policy has been in force. Premiums on policies are payable in advance, subject to the usual grace period of sixty days. Remittances are made by the firm to the insurance companies on monthly balances, charging itself a proportional part of any overriding commissions previously received in respect of any business which was cancelled or reinsured in another company, and crediting itself with the overriding commissions due on business written during the month. The books of the firm have been kept on an accrual basis; refunds of overriding commissions on account of cancellations of policies or reinsurance, and of new business, have been accounted as expense and income of the year they occurred. For the first time, at the close of 1923, there appeared on the firm's books a liability account denominated "Return

Commissions". Petitioner in computing business income for the year 1923, claims a deduction of $52,971.96, for the year 1925, $3292.98, and for the year 1926, $1947.77, the amounts credited to the contingent liability account at the close of those years.

It is obvious that the theory of petitioner is that we must anticipate such contingent liability to refund in subsequent years such an amount as the past experience of the business indicates on account of cancellation of policies and reinsurance, in the proportion of the gross commissions earned within the year as the total premiums cancelled during the preceding five-year period bears to the gross premiums written in the same period. To do so, we are required to compute the income of the three years in dispute upon a basis that will reflect the contingencies of the future.

Revenue taxation requires that one who receives a sum of money subject to his disposition should account for the same as income in the year he receives it, and not at some indefinite future time of his own selection. Should the practice urged by petitioner be followed, the collection of the revenues of the National Government would be uncertain, for the Government would be taking the chance that the money is still available for taxation during subsequent years and that the taxpayer is still solvent. Such reserves, as urged by petitioner, to cover contingent liabilities, are not allowable as deductions unless sanctioned by statute, and we do not find any such statute. Spring Canyon Coal Co. v.

Commissioner, 43 F. (2d) 78; Lucas v. American Code Co., 280 U. S. 445; Thomas Cronin Co. v. Lewellyn, 9 F. (2d) 974; Consolidated Tea Co. v. Bowers, 19 F. (2d) 974; Highland Milk Condensing Co. v. Phillips, 34 F. (2d) 777; Earle v. Commissioner of Internal Revenue, 38 F. (2d) 965. This has been the repeated holding of the Board of Tax Appeals. William J. Ostheimer, 1 B. T. A. 18; Uvalde Co., 1 B. T. A. 932; Jackson Casket & Manufacturing Co., 7 B. T. A. 1190; Landesman-Hirschheimer Co., 15 B. T. A. 64; and, Lane Construction Corp., 17 B. T. A. 826, which was affirmed in 49 F. (2d) 1080.

The conclusion we have reached sustains the orders of the Board of Tax Appeals in the three cases.

Orders affirmed.

WILBUR, Circuit Judge, concurring:

In addition to what is said by Judge Cavanah, I wish to add the following statement: As I understand the record the petitioner claimed, and was granted, the right to take from the income of the year 1923 all payments actually made in that year by reason of return of premium on policies written in previous years, and in addition to the allowance upon premiums actually returned during the year 1923 the petitioner set up a reserve of 22.38 per cent of all premiums collected during the year to take care of such return of commission as it was estimated would be required in future years according to the experience of the agency, or, to state the

matter differently, the agent returns as income only 77.62 per cent of the overriding commissions received by him as gross income and deducts therefrom the actual returns of premium made during the year. The total fire overriding commission for 1923 was $236,693.31; and 22.38 per cent thereof was $52,971.58. If this is true it is clear that the petitioner is not entitled to both deductions during the year 1923. If the percentage of 22.38 is reasonable it will make no difference in the long run to the petitioner whether the return commissions due to cancelled policies are deducted from the revenue of the current year or from a contingent fund set up, as petitioner claims the right to do.

[Endorsed]: Opinion and concurring opinion. Filed February 6, 1933. Paul P. O'Brien, Clerk.

United States Circuit Court of Appeals
For the Ninth Circuit.

No. 6812

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

ARTHUR M. BROWN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JUDGMENT.

Upon petition to review an order of the United States Board of Tax Appeals, this cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the orders of the said Board of Tax Appeals in this Cause be, and hereby are affirmed.

[Endorsed]: Judgment. Filed and entered February 6, 1933. Paul P. O'Brien, Clerk.

At a stated term, to wit, the October Term, A. D. 1932, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the Court Room thereof, in the City and County of San Francisco, in the State of California, on Tuesday the twenty-first day of March in the year of our Lord One Thousand Nine Hundred and Thirty-three.

Present: The Honorable CURTIS D. WILBUR, Senior Circuit Judge, Presiding, Honorable WILLIAM H. SAWTELLE, Circuit Judge, Honorable JULIAN W. MACK, Circuit Judge.

[Title of Cause.]

ORDER DENYING PETITION FOR A REHEARING.

Upon consideration thereof, and by direction of the Court, IT IS ORDERED that the petition of petitioner, filed March 8, 1933, for a rehearing of above cause be, and hereby is denied.

ORDER STAYING MANDATE.

GOOD CAUSE APPEARING THEREFOR, IT IS ORDERED that the mandate in the above-entitled matter be stayed until the application of the petitioner above named to the United States

Supreme Court, for a writ of certiorari, shall have been determined by the denial of the writ, or by final determination in that court if the writ is issued, or until the time to petition therefor shall have expired.

Dated, March 24, 1933.

CURTIS D. WILBUR,
Circuit Judge.

[Endorsed]: Filed March 4, 1933. Paul P. O'Brien, Clerk.

[Tile of Court and Cause.]

CERTIFICATE OF CLERK U. S. CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT TO RECORD CERTIFIED UNDER RULE 38 OF THE REVISED RULES OF THE SUPREME COURT OF THE UNITED STATES.

I, Paul P. O'Brien, as clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing two hundred eighty-four (284) pages, numbered from and including 1 to and including 284 to be a full, true and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of counsel for the petitioner and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

ATTEST my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 7th day of June, A. D. 1933.

[Seal] PAUL P. O'BRIEN,
Clerk.

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 9, 1933

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, limited to the question of the deduction on account of reserve.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1932

No.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Honorable the Associate Justices of the Supreme Court of the United States:

Petitioner asks that the cause in the United States Circuit Court of Appeals for the Ninth Circuit, entitled and numbered, Arthur M. Brown, Petitioner,

vs. Commissioner of Internal Revenue, Respondent, No. 6812, be certified to this court for review of the judgment therein (for judgment see R. 274-283, reported in 63 F. (2d) 66). That judgment affirmed three orders of the United States Board of Tax Appeals assessing deficiencies as to petitioner's income taxes for 1923, 1925 and 1926 ("Findings and Opinion" of the Board,—R. 54-69; 22 B. T. A. 678. "Decisions" of the Board,—R. 70-72). In this behalf your petitioner respectfully shows:

I.

JURISDICTION, PROCEDURAL STEPS AND STATUTES RELATING THERETO.

(a) Petitioner, as an individual, made return for his income tax for 1923, 1925, and 1926. Respondent assessed deficiencies: $17,923.03 for 1923, by his "60 day letter" of Dec. 22, 1927 (R. 20-25), $1,520.19 for 1925, by his "60 day letter" of Apr. 28, 1928 (R. 35-37), and $944.30 for 1926, by his "60 day letter" of Feb. 7, 1929 (R. 47-52).

(b) In due time, pursuant to § 274 of the Revenue Acts 1924 and 1926 (43 Stat. 297, 44 Stat. 55; 26 U. S. C. § 1048), and § 272 of the Revenue Act of 1928 (45 Stat. 852; 26 U. S. C. § 2272), petitioner filed petitions with the Board of Tax Appeals, for redetermination of the deficiencies. The petitions were filed, as to the 1923 tax, on Feb. 20, 1928 (Docket No. 35305; R. 11-25), as to the 1925 tax, on Jun. 6, 1928 (Docket No. 39157; R. 26-37), and as to the 1926

tax, on Apr. 1, 1929 (Docket No. 43432; R. 39-52). Respondent filed answers on Apr. 20, 1928 (R. 25-26), Aug. 6, 1928 (R. 37-38), and May 31, 1929 (R. 52-53). All three matters were set for hearing on May 14, 1930 (R. 1, 5, 8). At that time they were consolidated (R. 114-115). On Mar. 11, 1931 the Board promulgated its "Findings of Fact and Opinion" (R. 54-69; 115; 2, 5, 9). On Apr. 25, 1931, decisions, pursuant to the findings and opinion, were entered, redetermining the deficiencies in petitioner's taxes in the same amounts as assessed by respondent (R. 70-72; 2, 5-6, 9; 115).

(c) Agreeably to the Acts of Congress (Act of Feb. 26, 1926, §§1001 (as amended by Act of May 29, 1928, §603, 45 Stat. 873), 1002, 1003, and 1005, 44 Stat. 109-110; 26 U. S. C. §§1224-1228), and to Rule 38 of the Circuit Court of Appeals, for the Ninth Circuit, petitioner, being an inhabitant of the Ninth Circuit, petitioned that court to review said decisions. Separate petitions, containing assignments of error, were filed in each matter on Sept. 8, 1931 (R. 80-91; 93-101; 103-112), and notice duly given (R. 91-92; 102-103; 112-113). Pursuant to stipulations that the three matters might be consolidated for review and presented on one record (R. 73-80; 115), petitioner had settled and filed his "Consolidated Statement of Evidence" (R. 114-263). A single transcript was prepared. Pursuant to stipulation and order exhibits not set out in the statement of evidence were omitted in printing the record, with leave to refer to any matters in unprinted exhibits if set out in the briefs (R. 268-269).

(d) On Feb. 6, 1933 the Circuit Court of Appeals, for the Ninth Circuit, affirmed the orders of the Board (R. 282-283). On Mar. 8, 1933 and within the time allowed by Rule 29 of that court, that "a petition for rehearing may be presented within 30 days after judgment", petitioner filed, in that court, his petition for rehearing (R. 283). That petition was denied on Mar. 21, 1933 (R. 283).

Petitioner, agreeably to §1003 of the Act of Feb. 26, 1926 (44 Stat. 110; 26 U. S. C. §1226), §240 of the Judicial Code (36 Stat. 1157, as amended by 43 Stat. 938; 28 U. S. C. §347), and §8 of the Act of Feb. 13, 1925 (43 Stat. 940; 28 U. S. C. §350), asks that, upon certiorari, the judgment of the Circuit Court of Appeals, for the Ninth Circuit, be reviewed.

II.

ISSUES AND STATUTES INVOLVED.

The question for 1923, 1925 and 1926 is the proper method of returning "overriding commission" income from an insurance general agency business, and, particularly, is as to the proper year in which to deduct "overriding commission" received *but unearned and refunded.* Admittedly this item is to be deducted in computing income—the question is as to the method of return as throwing this item into one year or another. For 1923 there is an additional matter—whether a payment made to petitioner's sister under a written contract may be subtracted in computing taxable income.

The statutes involved are provisions of the Revenue Acts of 1921, 1924 and 1926 (since carried into the Revenue Acts of 1928 and 1932. Reference is made to the perpetuating provisions. The matters here presented are not as to provisions which have been discarded.) The quotations are taken from Title 26, U. S. Code, except as to the Act of 1921.

(a) Revenue Act of 1921, §200 (4), (42 Stat. 227; Fed. Stat. Ann. 1921, 123) provided:

> "The term 'paid' for the purposes of deductions and credit under this title, means 'paid or accrued' or 'paid or incurred', and the terms 'paid or incurred' and 'paid or accrued' *shall be construed according to the method of accounting upon the basis of which the net income is computed under § 212.*"

The Revenue Acts of 1924 and 1926, §200 (d) (43 Stat. 254, 44 Stat. 10; Fed. Stat. Ann., 1924, 82; 26 U. S. C., §931) provided:

> *"The terms 'paid or incurred' and 'paid or accrued', shall be construed according to the method of computing upon the basis of which the net income is computed* under §953 or §984. The deductions and credits provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid *or incurred', dependent upon the method of accounting* upon the basis of which the net income is computed under §953 or §984, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

(See Revenue Acts of 1928 and 1932, §§43, 48 (c); 45 Stat. 805, 807; 26 U. S. C., §§2043,

2048; 47 Stat. 185, 187, 26 U. S. C., §§3043, 3048.)

(b) Revenue Acts of 1921, 1924 and 1926, §212 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 133; 43 Stat. 267, Fed. Stat. Ann. 1924, 94; 44 Stat. 23, 26 U. S. C. § 953) provided:

"(a) In the case of an individual the term 'net income' means the gross income as defined in section 954 of this title, less the deductions allowed by sections 937 and 955.

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period, (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

(See Revenue Acts of 1928 and 1932, §§21, 41; 45 Stat. 797, 805, 26 U. S. C., §§2021, 2041; 47 Stat. 178, 185, 26 U. S. C., §§3021, 3041.)

(c) Revenue Acts of 1921, 1924 and 1926, §213 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 134; 43 Stat. 267, Fed. Stat. Ann. 1924, 95; 44 Stat. 23, 26 U. S. C., §954), after specifying items included in gross income, provided:

"The amount of all such items shall be included in the gross income for the taxable year in which

received by the taxpayer *unless, under methods of accounting permitted under subdivision* (b) *of section 953, any such amounts are to be properly accounted for as of a different period.*"

(See Revenue Acts of 1928 and 1932, §42; 45 Stat. 805, 26 U. S. C., §2042; 47 Stat. 185, 26 U. S. C., §3042.)

(d) Revenue Acts of 1921, 1924 and 1926, §214 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 135; 43 Stat. 269, Fed. Stat. Ann. 1924, 97; 44 Stat. 26, 26 U. S. C., §955) provided:

"(a) In computing the net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid *or incurred* during the taxable year in carrying on any trade or business, * * *."

(See Revenue Acts of 1928 and 1932, §23; 45 Stat. 799, 26 U. S. C., §2023; 47 Stat. 179, 26 U. S. C., §3023).

(e) In connection with the above, see Regulations 69, Art. 21-24, 36, 91, 1523, 112; Regulations 74 and 77, Art. 41 (a), 321-323, 334, 335, 341, 342.

III.

SUMMARY STATEMENT OF FACTS.

(a) The income is from an insurance general agency business, conducted under the name of Edward Brown & Sons. There is a question as to the interest in this business of one daughter of Edward Brown (a

sister of petitioner). This is noticed below. Aside from such interest, the proprietors of this business were:

From 1896 to 1904 Edward Brown and his two sons, Arthur M. Brown, your petitioner, and Herbert H. Brown; from 1904, when Edward Brown died, until August 1922, when Herbert H. Brown died, Arthur M. Brown and Herbert H. Brown; from the death of Herbert H. Brown to Jan. 1, 1924, petitioner as sole proprietor; from Jan. 1, 1924, petitioner and his son, Arthur M. Brown, Jr. (R. 125, 130, 131, 56). The income involved is, then, the income of petitioner doing business as Edward Brown & Sons, for 1923, and petitioner's share of the partnership income of petitioner and his son, doing business as Edward Brown & Sons, for 1925 and 1926.

(b) An insurance general agent is a wholesaler of insurance, and, in a given territory, is manager for the insurance company represented. The local agent solicits and procures the business to be written. His functions then cease. Here the general agent's functions begin. His duties are performed, as to each policy, throughout its life. Policies are written for one, three or five years. The general agent represents his company generally, and attends to all of its affairs. At every moment while policies are current he has duties as to those policies. Details of the duties and functions of the general agent will be found in the Opinion of the Circuit Court of Appeals, 63 F. (2d) 66, R. 277-278, in the Findings and Opinion of the Board, 22 B. T. A. 678, R. 60, 61, and in even greater detail in the evidence, R. 168-179. For distinction be-

tween local agent and general agent see R. 125, 167-169.

(c) The compensation of the local agent is a policy commission, or commission for getting business. It is fixed by an independent organization, the Board of Underwriters (R. 126). By statute in many of the states in which Edward Brown & Sons operated, it was required that policies be countersigned by a resident agent, who "shall receive the full commission when the premium is paid".

Idaho, Compiled Statutes, §5009, Statutes of 1915, Chapter 145, §2, p. 318, (R. 167);

California, Political Code, §633d;

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§149, 160, 183-186, 197;

Nevada Revised Laws, §1304, as amended by Statutes 1919, 392;

Montana Code, §6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29;

Wyoming, Insurance Laws, §11, Laws 1921, Chapter 142, §3;

Oregon, Insurance Laws, §4, Olson, Oregon Laws, §6333, Laws 1923, Chapter 115, §1, p. 172.

Whether such statutes were in force or not, the same rule was followed by Edward Brown & Sons. The local agent received the policy commission (R. 167, 168).

The compensation of the general agent is fixed by contract between himself and the company. Edward Brown & Sons represented six fire insurance companies. Relations with four of the companies were defined by writings (Petitioner's Exhibits 5, 6, and 7, R. 131-165); with two by conversations and course of dealing. The business of all companies was conducted in the same way—the same functions were performed for each—relations different only as to rate of compensation paid (R. 165, 166).

(d) The compensation received by Edward Brown & Sons recognizes the time element which entered into its earning, and that it was earned only over the periods of the lives of the policies written through Edward Brown & Sons.

The general agent received a contingent "commission"—a percentage of the net earnings, if any, on the business written through the general agent (as to which there is no question)—and an "overriding commission"—a percentage of the *net* premiums on business written through the general agent. Net premiums are gross premiums, less cancellations (by the company or by the assured), and less net reinsurance effected (R. 246, 247, 257, 166 and Petitioner's Exhibits 5, 6 and 7).

Where a premium is paid, the general agent retains his overriding commission on remitting to the company. On cancellation of a policy the general agent, whether during the currency of the agency or afterwards, must return the unearned compensation

—the part proportionate to the return premium (see Petitioner's Exhibits 5, 6 and 7 and R. 179). This result follows, without express provision to that end, where compensation is a percentage of *net* premiums. It requires return of unearned "overriding commission", even after termination of the agency relationship (*Milwaukee Mechanics Ins. Co. v. Warren,* 155 Cal. 346; *National Union Fire Ins. Co. v. Mason,* 21 Cal. App. 297). During the tax years here in question the general agency of Edward Brown & Sons for United States Merchants & Insurance Shippers Company was terminated. Edward Brown & Sons, pursuant to this rule, was required to repay, and did, repay the portions of compensation received which related to the unearned premium (R. 179).

The overriding commission of the general agent (unlike the policy commission of the local agent, which is earned when the business is written) is only a percentage of the premium income of the company, and, like that premium income, is earned only over the life of the policy. If the policy is prematurely terminated, a proportionate and proper refund must be made. This is known as "return commission".

(e) From long experience, the ratio of cancellations to business written can be predicted, and the relation of return commission to gross commission received accurately fixed. Edward Brown & Sons' own experience showed the proportion of overriding commission on business written in any year (whether for one, three or five years), of which return would have to be made.

Five Year Period	Gross Fire Premiums Written	Fire Premiums Cancelled	Ratio
1919 to 1923	$14,893,022	$3,333,104	22.38%
1920 to 1924	15,647,482	3,492,101	22.32
1921 to 1925	15,931,443	3,432,670	21.55
1922 to 1926	17,155,359	3,642,071	21.13

(Petitioner's Exhibits Nos. 28-32.)

In the fire insurance business, generally, cancellations run from 20% to 25% (R. 206).

(f) In 1902 Edward Brown, Herbert Brown, and petitioner entered into an agreement in writing defining their respective interests, and providing:

> "Before any division of profits is made the said partners agree to pay monthly to Jessie H. Jones, Edith H. Halton and Ethel Brown (the three daughters of Edward Brown and sisters of Arthur M. and Herbert H. Brown) the sum of Two Hundred Fifty (250) Dollars, and, Further, whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand (18,000) Dollars per annum, they will pay a one sixth (1/6) proportion of such excess to the said Jessie H. Jones, Edith H. Halton and Ethel Brown."
>
> (Petitioner's Exhibit 3, R. 127.)

The agreement then provided for payment to the heirs and executors of the three partners in the event of death of any of them. In 1905, following the death of Edward Brown, there was another agreement which could not be found (R. 129). In 1907, one of

the sisters having died, Mrs. Halton and Mrs. Crandall made the agreement here in question as a substitution for the previous agreement. This agreement has never been modified (R. 128-130). It provided that Mrs. Halton and Mrs. Crandall agreed "to accept from the firm of Edward Brown & Sons * * * the sum of Two Hundred and Fifty Dollars ($250) per month, commencing with the month beginning June 1, 1907, and ending only by mutual agreement in full satisfaction of all amounts which may be due, or may become due to us, or either of us, or the survivor of us, from said firm, * * * " (Petitioner's Exhibit 4, R. 129-130). Petitioner, pursuant to this agreement, paid $3,000 to Mrs. Halton in 1923. The partnership returns for 1925 and 1926 showed that in those years, and as a partner's share, Mrs. Halton received $3,000 and $2,200 (Petitioner's Exhibits 11 and 13).

IV.

METHODS OF ACCOUNTING AND MAKING RETURN.

(a) The books of Edward Brown & Sons were kept on an accrual basis (R. 195, 251, 257). The Board so found (R. 63). This is the standard and accepted method for insurance general agents (R. 251). The method of accounting has never been changed. The methods of return hereafter noticed, however they may differ, required no change in method of accounting or method of keeping the books, nor the changing of any figure on those books (R. 201, 211, 250-252).

(b) Until 1923 return of overriding commission was made by returning overriding commission received in any one year, less return commission on cancellations effected in that year. Policies were written for 1, 3 and 5 years. This resulted in charging against overriding commission received in one year on business written in that year, and from premiums paid in that year, return commission returned in that year, on cancellation of business written in an earlier year, where the commission, a part of which was returned, was received in the earlier year from a premium received in an earlier year. *Under this method return commissions were charged, not against the commissions and the year to which the same related, but against later years.* In the case of return commission relating to policies written for the United States Merchants & Shippers Insurance Company, after termination of the agency for that company, such method would charge return commission, not against that company and the policies to which the same related, but against commissions received on different policies written for wholly different companies.

(c) For 1923, the first year in which petitioner was sole proprietor of the business, conceiving that this method was inaccurate, and that the return commission should be charged against the very commissions which were being returned, and as a charge properly attributable to the process of earning those commissions, during the period in which they were received (cf. *U. S. v. Anderson*, 269 U. S. 422, 70 L. ed.

347 and Reg. 69, Art. 112, Reg. 74 and 77 Art. 342), petitioner, set up a figure on his books (Petitioner's Exhibit No. 31), dictated by past experience as to cancellations and return commission (see paragraph III (e) above), representing the liability to return commission, by reason of future cancellations of 1923 business. This was deducted from the commission received in 1923 in making return. This method was followed for subsequent years. Under this method return commission on account of cancellation of policies written in 1923, where the cancellation occurred in later years, was charged, not against the commissions received from other policies written in the year of cancellation, but against this reserve. This procedure was followed for later years. The amount of this reserve for 1923 was $52,971.96. The net additions to the reserve for 1925 and 1926 were $3,292.98 and $1,947.77. With the exception of the $3,000 paid to Mrs. Halton in 1923 (see below), these figures are the figures in dispute. The disallowance of these figures gave rise to the deficiencies assessed (R. 245-247). Returns made under this method were made in accordance with the books and on the same basis as that upon which the books had been kept (R. 232-234).

(d) Before the Board petitioner urged a third method, suggested to him by Acts of Congress. This was to return in each year only the compensation earned in that year, computed not by taking compensation received, less a figure representing the obligation to return a part of it on cancellation of policies, which

figure was determined by past experience of cancellation, but by taking the actual policies in force in a given year (whether written in that year or not), computing the premiums earned *in the year,* and arriving at the compensation earned in any year. Petitioner urged that the return be made on a basis of compensation earned by pro-rating the "overriding commission" over the life of each policy on a strict actuarial basis. Exhibits showing the precise figures for petitioner's income on such basis, for the years 1923, 1925 and 1926, are in evidence, and show that the deficiency assessed was improper (Petitioner's Exhibits 20-28).

V.

ACTION OF THE COMMISSIONER AND THE BOARD.

(a) The respondent and the Board of Tax Appeals refused to permit petitioner to return his income for 1923, or his share of the partnership income of Edward Brown & Sons for 1925 and 1926 in accordance with either of the methods referred to in paragraph IV (c), or in IV (d) above, but required him to make his return in accordance with the method in paragraph IV (b) above, with resulting deficiencies. While the books are kept on an accrual basis, petitioner is forced to make return as to certain disbursements on a cash basis.

(b) As to 1925 and 1926 respondent permitted deduction of the payments made to Mrs. Halton pursuant to the agreement set out in paragraph III (f) above, but refused to permit this for 1923.

VI.

DECISION OF THE CIRCUIT COURT OF APPEALS AND REASONS WHY THAT DECISION SHOULD BE REVIEWED.

(a) The Circuit Court of Appeals in affirming the orders of the Board announced, as the grounds for its decision, the following:

1. The payment to Mrs. Halton was not allowed as a deduction because the court was unable to determine what interest, if any, she had in the business, as a partner, or that she rendered any service which would authorize allowance of the item as a business expenditure (R. 276-277).

2. As to the overriding commission income it was said that money subject to one's disposition should be returned in the year in which received, "and not at some indefinite future time of his own selection"; that the method urged by petitioner would make the collection of revenues uncertain and force the Government to gamble on the taxpayer's solvency; that reserves, such as set up, are to cover contingent liabilities and are not authorized as deductions. The concurring opinion as an added ground states that, "it will make no difference in the long run to the petitioner whether the return commissions due to cancelled policies are deducted from the revenue of the current year or from a contingent fund set up" (R. 279, 281).

(b) The determination of the Circuit Court of Appeals as to the Halton matter should be reviewed for the following reasons:

1. The Circuit Court of Appeals has decided an important question of federal law, which has not been, but which should be, settled by this court. It has held that where a person, entitled to participate in the income of a business, as a matter of original participation therein, under a writing, receives his participation, still, unless the person to whom such payment is made performed services, as the consideration for that participation, or sustained the conventional relation of partner of the persons actively conducting the business, the amount paid is to be included in the gross income of the active proprietors of the business and taxed to them. It has indicated that the only proprietors of a business to whom income is to be taxed are those who (1) perform services, or (2) sustain the conventional relation of partners.

2. The holding is in conflict with the reasoning and holding of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner of Internal Revenue v. Olds*, 60 F. (2d) 252.

(c) The determination of the Circuit Court of Appeals as to the method of handling return commissions should be reviewed for the following reasons:

1. The question here presented is not peculiar to petitioner. It is one of general concern. It is a question which presents itself in exactly the same way as to all insurance general agents. But more than that, the same question presents itself to all persons who, accounting on an *accrual* basis, receive money as to which there is an obligation to return a part, and where repayment, though conditional as to any par-

ticular component part of the whole, is not uncertain as to the total amount of return, but the total amount to be returned can be fixed on the basis of experience.

2. The decision of the Circuit Court of Appeals is in conflict with applicable decisions of this court, notably:

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;
American National Company v. U. S., 274 U. S. 99, 71 L. ed. 946;
Niles Bement Pond Co. v. U. S., 281 U. S. 357, 74 L. ed. 901;
Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234;
Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111.

And if it be said that the principles of these cases are not controlling, then—

3. The court below has decided an important question of federal law, which has not been, but which should be, settled by this court.

4. The determination of the court below as to reasoning and result is in conflict with the reasoning and result of the Circuit Court of Appeals for the Fourth Circuit in

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, 56 F. (2d) 1028;

and also the reasoning and holding in

Alpha Portland Cement Co. v. U. S., 76 Ct. Cls. 680, followed in

La Salle Cement Co. v. Commissioner of Internal Revenue, 59 F. (2d) 361, 362-363 (C. C. A. 7).

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, supra, expressly disapproves a line of cases in the Board of Tax Appeals, two of which are relied upon by the Circuit Court of Appeals in its opinion—*Jackson Casket & Mfg. Co.,* 7 B. T. A. 1190 and *Landesman v. Hirschheimer Co.,* 15 B. T. A. 604.

WHEREFORE, your petitioner prays that a writ of certiorari issue under the seal of this court, directed to the Circuit Court of Appeals for the Ninth Circuit, commanding that court to certify and forward to this Court a full transcript of the record and proceedings in the cause, to the end that this cause may be reviewed and determined by this court, and that the judgment of the Circuit Court of Appeals herein be reversed, and for such other relief as, the premises considered, is proper.

Dated: June 12th, 1933.

PETER F. DUNNE,
Counsel for Petitioner.

ARTHUR B. DUNNE,
J. ELLIOTT COOK,
Of Counsel.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1932

No.....

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF
in Support of Petition for Writ of Certiorari.

Reference has already been made to the opinion below (p. 2 of the Petition) and to the procedural steps and statutes upon which the jurisdiction of this court rests (Pet. Par. I, particularly Subd. (d)). The facts have been stated (Pet. Pars. III, IV, V, and VI(a)).

SPECIFICATION OF ERRORS.

The court below erred in that while the books of petitioner were kept on an accrual basis, petitioner is

required to account for return overriding commission income on a cash receipt and disbursement basis; it erred in refusing to permit the petitioner to deduct, in ascertaining taxable income, a liability incurred in the years in question to return overriding commission received upon cancellation of policies to which the same related, where the amount of such return commission could be ascertained from the past experience of the business.

The court below erred in determining that to set up a fund to meet a liability incurred, the amount of which is determinable from experience of the business, is not countenanced by the statutes even where the books are kept on an accrual basis. It erred in not permitting petitioner to return income only as earned, on a strict actuarial basis, if the basis selected by him in making his return was improper. It erred in determining that overriding commission of petitioner was earned when received, and must be returned for the year in which received, where books were kept on the accrual basis.

The lower court erred in determining that the $3,000 paid to Mrs. Halton was not paid to her by way of original participation in the profits of the business, and in holding that the same was taxable to the active proprietor or proprietors of the business.

In this regard, reference is also made to paragraphs VI(b) and VI(c) of the petition, and to the petitions for review (R. 86-89; 97-100; 108-110).

ARGUMENT.

I.

RETURN OF OVERRIDING COMMISSION.

Under the income tax statutes, gains and losses for tax purposes are computed for annual periods, and deductions are taken in the year in which the same are sustained—"paid or incurred" (see Statutes, Par. II of Pet.).

Martin v. Commissioner of Internal Revenue, 61 F. (2d) 942, 944 (C. C. A. 2);

Burnet v. Sanford Brooks Co., 282 U. S. 259, 75 L. ed. 383;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347.

The basic principle is that the return shall be made in such a way as to clearly reflect the truly taxable income. To this end, the taxing statutes have been amended from time to time. The most fundamental changes were those made by the Acts of 1916 and 1918. The first permitted the taxpayer to make his return on a basis other than cash receipts and disbursements if his accounts were kept on such other basis. The second, and the later acts, make it mandatory for taxpayers to use their bookkeeping basis as the basis for making their return. The effect of these statutes was the introduction of the accrual method as a basis for making return.

Niles Bement Pond Co. v. U. S., 280 U. S. 357, 74 L. ed. 901;

Aluminum Castings Co. v. Routzahn, 24 F. (2d) 230; 31 F. (2d) 669 (C. C. A. 6), 282 U. S. 92, 75 L. ed. 234.

The purpose of the change, and of permitting returns "in accordance with the method of accounting regularly employed in keeping the books" of the taxpayer (and consequently in accordance with the accrual basis where such was the basis for keeping the books), "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses INCURRED *in and properly attributable to the process of earning income during that period.*"

U. S. v. Anderson, supra;
Aluminum Casting Co. v. Routzahn, supra;
Niles Bement Pond Co. v. U. S., supra;
Miller & Vidor Lumber Co. v. Commissioner of Internal Revenue, 39 F. (2d) 890 (C. C. A. 5);
Reg. 69, Art. 24; Reg. 74, Art. 323;
Reg. 69, Art. 22; Reg. 74, Art. 321;
Reg. 69, Art. 23; Reg. 74, Art. 322.

It is the essence of the accrual system that income due and accrued, though not yet paid, be treated as received. Correspondingly, it is proper to charge against income any item of outgo incurred in the year in question, and attributable to the process of procuring the income of the year in question, even though the outgo will not be paid until a later time.

This is true even where the exact amount of the outgo is uncertain, provided that from past experience the amount of that outgo can be fixed with reasonable accuracy.

U. S. v. Anderson, supra;

American National Co. v. U. S., 274 U. S. 91, 71 L. ed. 946;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111;

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, 56 F. (2d) 1028 (C. C. A. 4);

Alpha Portland Cement Co. v. U. S., 67 Ct. Cls. 680;

La Salle Cement Co. v. Commissioner of Internal Revenue, 59 F. (2d) 361, 362-363 (C. C. A. 7);

Klein, Federal Income Taxation, 106, 130-137.

Where the total income and outgo is made up of a multitude of small items, and where the gross result of all of the items can be accurately foretold on the basis of experience, the foregoing rule applies even where there may be uncertainty as to what particular component items will ultimately enter into the final figure.

"Even though there be contingencies as to any particular account, if the experience of the company is such that upon the accounts taken as a

whole it is possible to predict with substantial accuracy what the discount will be, a deduction in anticipation of same should be allowed. It is the total of the accounts which is considered in computing income, and, if the discount which will be allowed from this total can be determined with reasonable certainty, there is no reason why the same should not be deducted."

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, supra.

This court expressed the rule in *Lucas v. American Code Co.,* supra, as follows:

"Generally speaking, the income tax law is concerned only with realized losses, as with realized gains. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. * * * It may be assumed that, since the company kept its books on the accrual basis, the mere fact that the exact amount of the liability had not been definitely fixed in 1919 did not prevent the deduction as a loss of that year of the amount later paid."

Manifestly, when at the moment overriding commission income was received, an obligation was incurred to return part of it upon cancellation of the policies to which the same related, that commission was not the petitioner's to do with as he pleased. He was not that much richer. If he were to honestly meet his obligations, he could not spend that money.

As matter of sound accounting and business, he must set aside a sum equivalent to what his experience told him must be returned. His legal duty was to keep himself in condition to perform his obligation to refund return commission. The obligation to return commission in 1924, for example, on policies written in 1923 but cancelled in 1924, is clearly attributable to the receipt of commission in 1923, and is a proper charge against the receipt of that commission.

One peculiar result of the method insisted upon by the Commissioner, and sanctioned by the court below, after a general agent has ceased to do business with one company, has already been pointed out (see Pet., Par. IV (b)). Another example will point the impropriety of this method. Assume that petitioner received overriding commission income for business written in 1923. Certainly he is not to pay a tax on the part of that which is returned on cancellations. But assume that he goes out of the general agency business at the end of 1923. Since his commissions are on net premiums, he will still be required to make return on cancellation of policies (*Milwaukee Mechanics Ins. Co. v. Warren,* 155 Cal. 346; *National Union Fire Ins. Co. v. Mason,* 21 Cal. App. 297). But if he has not been permitted to set up a reserve, in 1923, against which to charge these return commissions, against what are they to be charged after he has gone out of business and is no longer in receipt of income?

The Regulations have, in several instances, recognized the propriety of setting up reserves to take

care of future contingencies related to the income against which the reserves are charged. Thus reserves for bad debts are permitted (Reg. 69, Arts. 151-155; Reg. 74, Arts. 191-195). Again, special provision has been made in the case of long term contracts (Reg. 69, Art. 36; Reg. 74, Art. 334). Compare the situation with installment sales contracts (Reg. 69, Arts. 23, 42; Reg. 74, Arts. 322, 351). The permitting of reserves for redemption of trading stamps given on purchase of articles is in strict analogy to the situation here (Reg. 69, Art. 91; Reg. 74, Art. 335).

The following cases, already noticed, deal directly with the question of reserves, related to the income against which the reserve is charged, made up of a number of small items from out of a greater number of items, the amount of which is dictated by experience.

Virginia-Lincoln Furniture Co. v. Commissioner of Internal Revenue, supra;

Alpha Portland Cement Co. v. U. S., supra;

La Salle Cement Co. v. Commissioner of Internal Revenue, supra.

Against these considerations and authorities, it is first suggested by the court that the taxpayer should account for income in the year in which he received it and not at some indefinite future time of his own selection. If it is meant that income received must be returned, without deduction for liabilities concurrently incurred although not yet paid, the statement, we say with deference, is inaccurate and in conflict with the decisions of this court, where the books are

kept on the accrual basis. As to the implication that the petitioner here is seeking to return his income "at some indefinite future time of his own selection", there are several answers. Whether the return be made by returning income received less a reserve as suggested in the petition, paragraph IV (c), or be returned on a strict pro rata and actuarial basis, as earned, as suggested in paragraph IV (d) of the petition, the income will not be returned at some future and indefinite time, but the time and amount of returned is dictated strictly by consideration of the life of the insurance policies to which the commission relates. *The time and method selected by the petitioner, far from being indefinite and of his own selection, are the exact methods which Congress prescribed for fire insurance companies.*

Through the Revenue Act of 1918, fire insurance companies were required to return their income, as other corporations did, except that Section 12 (39 Stat., 767, as amended; Fed. Stat. Ann. 1918, 329) specifically permitted deduction "in the case of fire insurance companies" of "the net addition, if any, required by law to be made within the year to reserve funds". This court has held that, "unearned premium reserve" is a familiar type of insurance reserve and a strictly technical reserve within the meaning of this statute (*Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297, decided under the Act of 1913). Our overriding commission income is merely a percentage of the premium income of the companies, and our unearned overriding commission re-

serve is merely a percentage of the unearned premium reserve of the companies themselves. The companies set up a reserve for premiums which must be returned, and we set up a reserve which is a percentage of that, for our share—the return commission. Our income is a percentage of that of the insurance companies, it is earned over the life of the policies, and we returned it in the same way that Congress had the insurance companies return their income.

The second method of return suggested by petitioner to the Board (par. IV(d) of the petition) was likewise suggested by an Act of Congress. In 1921 Congress determined that in the case of fire insurance companies it would be more accurate to have premium income returned on a pro rata basis, returning the income actually earned within the year. Accordingly, by § 246 of the Revenue Act of 1921, it was provided that companies other than mutual and life should make return on the following basis: Return as gross income "the combined gross amount earned during year, from investment income and from underwriting income * * *." The Act then proceeded as follows:

> "The term 'underwriting income' means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;
>
> "The term 'premiums earned on insurance contracts during the taxable year' means an amount computed as follows:
>
> "From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums and premiums paid for re-

> insurance. To the result obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

This statute was carried into the later acts. See 26 U. S. C., § 1006 (Revenue Act of 1924 and 1926, § 246, 43 Stat. 290, and 44 Stat. 48), 26 U. S. C., § 2204 (Revenue Act of 1928, § 204, 45 Stat. 844), 26 U. S. C., § 3204 (Revenue Act of 1932, § 204, 47 Stat. 225).

These statutes in terms apply only to insurance companies, not to general agencies. But Congress has determined what, as a matter of fact, will truly reflect underwriting income. That method, as a matter of fact, will just as truly reflect an income which is only a percentage of the premium income of the insurance companies.

Next, the opinion states that the practice urged by us would make the collection of revenues uncertain and make the Government gamble upon the continued solvency of a taxpayer. If this is true, the history of the various tax statutes will indicate that this is a risk that Congress has been willing to take. But we say with deference, that the statement is not accurate. If a proper method of return shows that the Government is entitled, in a particular year, to only a given amount as tax, that in itself is a complete answer. If, in arriving at the amount of the income to be taxed, allowance is made for obligations owed to third persons, and if the taxpayer does not in fact meet those

obligations in the future, the loss is not that of the Government but of the obligees.

Finally, it is said that reserves to cover contingent liabilities are not allowed as deductions unless sanctioned by statute. The cases upon which we rely, as indicating that such a reserve as was sought to be set up here is properly allowable, have already been noticed. It remains only to say that an analysis of the cases cited will not support the holding of the court here.

Three of the cases cited and relied upon were cases of an attempt to deduct an amount as a "reserve" against a single isolated and *disputed* claim, and this reserve was attempted to be set up in advance of determination of either liability itself or the amount of any liability.

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Consolidated T. Co. v. Bowers, 19 F. (2d) 382 (D. C.);

Lane Construction Corp., 17 B. T. A. 826, 49 F. (2d) 1080 (C. C. A. 2).

The *Lucas Case* is expressly distinguished in *Virginia-Lincoln Furniture Co. v. Commissioner*, supra.

Spring Canyon Coal Co. v. Commissioner, 43 F. (2d) 78 (C. C. A. 10) was an attempt to deduct a so-called "reserve" to meet possible liability on tort claims, where, in truth, the facts—the accidents—upon which such claims might be predicated, had not yet occurred.

Highland Milk Condensing Co. v. Phillips, 34 F. (2d) 777 (C. C. A. 3), was an attempt to deduct repayments made to buyers of merchandise to protect them against a declining market. There was no past experience for such a deduction, either as to amount, time, or necessity. It was a single, isolated, and unusual matter.

Earle v. Commissioner, 38 F. (2d) 965 (C. C. A. 1), did not involve any question of deductions for liabilities, contingent or otherwise, but presented a question as to the proper method of return of a partner's distributive share upon dissolution of the partnership by death.

William J. Ostheimer, 1 B. T. A. 18, has little to recommend it, and is believed out of harmony with the views of this court. Be that as it may, the case has no analogy here. There a reserve to meet a possible liability to return leased chattels in as good condition as when they were let, was set up because the lessee was faced with the impossibility of the renewal of the lease due to national prohibition. No basis for the "reserve" was shown. It is to be noticed that one member of the Board of Tax Appeals dissented.

Thomas Cronin Co. v. Lewellyn, 9 F. (2d) 974 (D. C.) and *Uvalde Co.,* 1 B. T. A. 932, involved street paving contracts. The contractor was paid at the completion of his work. According to his contract he was required to repair any defects which might appear within a stated length of time. Accordingly, he set up a fund sought to be deducted to meet the anticipated expenses. It was held that this was not a proper de-

duction. The amounts were apparently based on pure estimate, and it was found that it was impossible on any basis to determine the amount necessary to be deducted. In addition, it is to be noticed, that if the contract were properly performed in the first instance, there would be no defects and no expense of repair. This is expressly pointed out in the *Thomas Cronin Co. Case.* These cases have been severely commented on by text writers. See *Montgomery, Income Tax Procedure,* 1927 Ed. 239, 241, 244, 265 and 268; *Klein, Federal Income Tax,* 137 (quoted with approval in *Virginia-Lincoln Furniture Corp. v. Commissioner,* supra), stating that "it is unthinkable that a higher tribunal, or the Board itself, will not change the situation sooner or later".

The other two authorities cited are *Jackson Casket & Mfg. Co.,* 7 B. T. A. 1190, and *Landesman-Hirschheimer Co.,* 15 B. T. A. 604. These are discount cases —customers were permitted a discount on performance of certain conditions. A reserve was set up to meet this discount. This reserve was disallowed. But this line of cases did not stop here. It was continued, and the rule of these cases followed in the *Virginia Table Case,* another discount case. This case was appealed to the Circuit Court of Appeals for the Fourth Circuit as *Virginia-Lincoln Furniture Corp. v. Commissioner,* 56 F. (2d) 1028, to which reference has been made several times. The court reversed the Board of Tax Appeals, and expressly disapproved this line of cases in the Board. The order in the *Landesman-Hirschheimer Co. Case* was affirmed

on appeal, but this was solely upon the ground that the record was incomplete (44 F. (2d) 521—C. C. A. 6.)

In the concurring opinion it is first suggested that we are not entitled to deduct a reserve, and also the premiums actually returned. This is conceded, and the exhibits put into the record, by the petitioner should show adjustments to prevent duplicate deduction (see *Virginia-Lincoln Furniture Corp. v. Commissioner,* handling a similar situation). It is also said that if the deductions sought to be taken are reasonable, it will make no difference in the long run how the returns are made—whether on the basis insisted upon by respondent, or on the basis insisted upon by petitioner. It is believed that this suggestion falls into error in two respects. In the first place, it is necessary to allocate income properly to the various years because of the tax rates. They vary from year to year, and are graduated according to amount of income. In the second place, "income taxes are levied upon the net income for an annual accounting period. Gains in one period may not be offset by losses in another" (*Earle v. Commissioner,* supra). And if the suggestion is correct it cuts both ways—it applies equally to the Government. It indicates that the method we suggest will not unduly prejudice the Government, and, accordingly, there is no practical reason for not permitting a return in accordance with the proper construction of the statute.

The opinion in *Virginia-Lincoln Furniture Corp. v. Commissioner,* 56 F. (2d) 1028, is very full. The

court in that opinion does not merely announce a result—it argues the matter out. We respectfully direct attention to that case.

II.

THE HALTON MATTER.

The Commissioner rejected the payment made to Mrs. Halton upon the ground that it was a capital expenditure. The Board does not approve this. To the contrary, it says, "Nor can we say * ** that the amount * * * was a capital expenditure" (R. 65).

There is not a word to show that the payment was in fact a capital expenditure. There is a showing that by reason of a contract Mrs. Halton was given a participation in the business. What the consideration for that contract was is immaterial—indeed, had her interest as a proprietor in the business been given to her as a gratuity, still the earnings, in so far as she was entitled to them, would have been hers, and, consequently, taxable to her.

Commissioner v. Olds, 60 F. (2d) 252 (C. C. A. 6).

In addition, there is a presumption that the findings of the Commissioner are correct. This is the usual presumption in favor of the legality of the acts of public officials.

Avery v. Commissioner, 22 F. (2d) 6 (C. C. A. 5);

Merchants etc. Co. v. Burnet, 49 F. (2d) 56 (C. C. A. 4);

Williams v. Commissioner, 45 F. (2d) 61 (C. C. A. 5);

Brooks v. Commissioner, 35 F. (2d) 78 (C. C. A. 4).

When the Commissioner makes two determinations, one at variance with the other, the later presumption prevails, for—

> "There is a presumption that he performed his duty, that is, that he acted upon all of the facts before him, *including new and different ones. United Staies v. Chemical Foundation,* 272 U. S. 1, 14, 47 S. Ct. 1, 71 L. ed. 131. This presumption of the existence of such new facts is not inconsistent with the presumption attaching to the first assessment, that the Commissioner acted upon all of the facts then before him."

Austin Co. v. Commissioner, 35 F. (2d) 910 (C. C. A. 6).

The Commissioner, as to the taxes for 1925 and 1926, permitted the payments to Mrs. Halton to be returned as a proprietary participation by her.

The court below suggests no reason why the payment made to Mrs. Halton should not be returned to her as a participation by her. Neither did the Board. The fact that the contract was supported by a consideration would not make the payment a capital expenditure. A capital expenditure means that money which has come to the taxpayer and belonged to him is spent by him to acquire something. But if by con-

tract—as a partnership contract or other participating contract—the flow of income is intercepted before it gets to the taxpayer, it never becomes his and cannot be a capital expenditure by him, even if he did receive a consideration for entering into the contract.

CONCLUSION.

It is respectfully submitted that both of the matters presented here present questions affecting taxpayers other than the petitioner, and that the matters here presented should be determined by this court because of their inherent importance, and to the end that there shall be uniformity among the circuits.

Dated at San Francisco, California, June 12th 1933.

PETER F. DUNNE,
Counsel for Petitioner.

ARTHUR B. DUNNE,
J. ELLIOTT COOK,
Of Counsel.

Corrections and Additions

Brief:

The following are the citations for cases, which were not available to us when the brief went to press:

Burnet v. Commonwealth Imp. Co., 287 U. S. 415, 77 L. ed. 399;

Burnet v. Huff, 288 U. S. 156, 77 L. ed. 670;

Burnet v. S. & L. Bldg. Corp., 288 U. S. 406, 77 L. ed. 861;

Mass. M. L. Ins. Co. v. U. S., 288 U. S. 269, 77 L. ed. 739;

Murphy Oil Co. v. Burnet, 287 U. S. 299, 77 L. ed. 318;

Tait v. Western Maryland Ry. Co., 289 U. S. 620, 77 L. ed. 1405.

Page 40: Add to the *American Can* case, *Peyton DuPont Securities Co. v. Commissioner*, 66 F. (2d) 718 (C. C. A. 7).

Page 41: Add to the *Kirby Lumber* and *Old Colony* cases, *Welch v. Helvering*, ...U. S....., 78 L. ed. 1 (Adv. Op., Oct. Term 1933, No. 33).

Pages 41 and 42: Compare, on the proposition that the test is not expressed in the statute but is left to be worked out by the practicalities of the business facts, *Welch v. Helvering*, supra.

Page 52: Add to the *Miller & Vidor* case, *Peyton DuPont Securities Co. v. Commissioner*, supra.

Page 60, line 20, should read: "to prevent again taxing income" etc.

Page 66, line 21, last word should be "methods".

Appendix:

Page xiii: The citation for *U. S. v. Anderson* should read, "269 U. S. 422, 70 L. ed. 347".

Page xxii, line 1: Should read "Then come".

Page xxxviii: The volume of the Journal of Accountancy in which Senator Hebert's article appears is Vol. XL, August 1925, No. 2.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1933

No. 187.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

I.

MATTER SOUGHT TO BE REVIEWED AND OPINION BELOW.

This matter is here on certiorari to review a judgment of the Circuit Court of Appeals for the Ninth Circuit, which affirmed three orders of the United States Board of Tax Appeals assessing deficiencies as to petitioner's income taxes for 1923, 1925 and 1926.

The opinions of the Circuit Court of Appeals are reported in 63 F. (2d) 66. The judgment will be found in

the record at page 282. The opinions will be found in the record at pages 274-281.

The findings and opinion of the United States Board of Tax Appeals are reported in 22 B. T. A, 678. The findings and opinion will be found in the record at pages 54-69, and the "decisions" will be found in the record, pages 70-72.

II.

GROUNDS OF JURISDICTION AND PROCEDURAL HISTORY.

The respondent assessed deficiencies as to petitioner's income tax for 1923, 1925 and 1926. Petitioner applied to the United States Board of Tax Appeals for relief. The Board assessed deficiencies in the same amounts as had respondent. On petition for review to the Circuit Court of Appeals for the Ninth Circuit that Court affirmed the orders of the Board. Accordingly, this matter is here agreeably to §1003 of the Act of Feb. 26, 1926 (44 Stat. 110; 26 U. S. C. §1226), §240 of the Judicial Code (36 Stat. 1157, as amended by 43 Stat. 938; 28 U. S. C. §347), and §8 of the Act of Feb. 13, 1925 (43 Stat. 940; 28 U. S. C. §350).

The judgment and opinions of the Circuit Court of Appeals for the Ninth Circuit were entered February 6, 1933 (R. 281-283). Rule 29 of that Court provides that "a petition for rehearing may be presented within 30 days after judgment". A petition for rehearing was filed on March 8, 1933, and denied on March 21, 1933 (R. 283). The petition for certiorari was filed in this Court

and the cause docketed on June 19, 1933, and the order allowing it was entered October 9, 1933.

The following were the procedural steps up to the determination of the Circuit Court of Appeals.

(a) Petitioner, as an individual, made return for his income tax for 1923, 1925, and 1926. Respondent assessed deficiencies: $17,923.03 for 1923, by his "60 day letter" of Dec. 22, 1927 (R. 20-25), $1,520.19 for 1925, by his "60 day letter" of Apr. 28, 1928 (R. 35-37), and $944.30 for 1926, by his "60 day letter" of Feb. 7, 1929 (R. 47-52).

(b) In due time, pursuant to §274 of the Revenue Acts 1924 and 1926 (43 Stat. 297, 44 Stat. 59; 26 U. S. C. §1048), and §272 of the Revenue Act of 1928 (45 Stat. 852; 26 U. S. C. §2272), petitioner filed petitions with the Board of Tax Appeals, for redetermination of the deficiencies. The petitions were filed, as to the 1923 tax, on Feb. 20, 1928 (Docket No. 35305; R. 11-25), as to the 1925 tax, on Jun. 6, 1928 (Docket No. 39157; R. 26-37), and as to the 1926 tax, on Apr. 8, 1929 (Docket No. 43432; R. 39-52). Respondent filed answers on Apr. 20, 1928 (R. 25-26), Aug. 6, 1928 (R. 37-38), and May 31, 1929 (R. 52-53). All three matters were set for hearing on May 14, 1930 (R. 1, 5, 9). At that time they were consolidated (R. 114-116). On Mar. 11, 1931 the Board promulgated its "Findings of Fact and Opinion" (R. 54-69; 115; 2, 5, 9). On Apr. 25, 1931, decisions, pursuant to the findings and opinion, were entered (R. 70-72; 2, 5-6, 9; 115).

(c) Agreeably to the Acts of Congress (Act of Feb. 26, 1926, §§1001 (as amended by Act of May 29, 1928,

§603, 45 Stat. 873), 1002, 1003, and 1005, 44 Stat. 109-110; 26 U. S. C. §§1224-1228), and to Rule 38 of the Circuit Court of Appeals, for the Ninth Circuit, petitioner, an inhabitant of the Ninth Circuit, petitioned that court to review said decisions. Separate petitions, containing assignments of error, were filed in each matter on Sept. 8, 1931 (R. 80-91; 93-101; 103-112), and notice duly given (R. 91-92; 102-103; 112-113). Pursuant to stipulations that the three matters might be consolidated for review and presented on one record (R. 73-80; 115), petitioner had settled and filed his "Consolidated Statement of Evidence" (R. 114-263). A single transcript was prepared. Pursuant to stipulation and order exhibits not set out in the statement of evidence were omitted in printing the record, with leave to refer to any matters in unprinted exhibits if set out in the briefs (R. 268-269).

III.

SUMMARY STATEMENT AND ISSUES PRESENTED.

In 1923, 1925, and 1926 petitioner was in receipt of income coming from the "overriding commissions" of an insurance general agency business. "Overriding commission" was in every case a percentage of the premium of policies written. It was paid as compensation for services performed throughout the life of the policies. The policies were for one, three and five years. On cancellation of a policy before its normal termination the general agent was required to refund a proportionate part of his overriding commission, determined by the proportionate part of the premium returned. Part of the

"overriding commission" income shown on the books in any one year was as to that year unearned and would be refunded. The amount of this refund could be accurately foretold from past experience.

The books were kept on the accrual basis. The full overriding commission, whether actually received or not, was shown in the year in which the policy was written. Admittedly, petitioner is not to be taxed on the part of the overriding commissions refunded.

The question is as to the proper method of return of overriding commission retained and on which a tax is to be paid—as to how the amount to be returned in any annual accounting period is to be fixed. More precisely, the question is which of the following methods of return should be used:

(a) Returning the full amount of commission shown on the books in the year in question, less, not the part of *that* commission to be returned, but, on the contrary, the actual cash return of commission in that year (being referable both to policies written in the year in question, and hence shown as a receipt in the year in question, and to policies written in an earlier year, and shown as a receipt in an earlier year). *This is treating commission received on an accrual basis and the commission refunded on a cash basis.* This is the method used by respondent.

(b) Returning the full amount of commission shown on the books in the year in question, less the liability to return a part of that on cancellation of the policies, which liability attached the moment the commission was entered on the books. The amount of liability set up

was dictated by experience. This is the method used in making the return.

(c) Returning only the amount of commission *earned* in any one year (whether referable to policies written in that year, or written in earlier years) by prorating the commission over the life of the policies. This was an alternative method urged by the petitioner before the Board and before the Circuit Court of Appeals.

IV.

STATUTES AND REGULATIONS INVOLVED.

The statutes involved are provisions of the Revenue Acts of 1921, 1924, and 1926. (Reference in each instance is made to the sections by which these provisions are carried into the Revenue Acts of 1928 and 1932.) The quotations are taken from Title 26, U. S. Code, except as to the Act of 1921.

(a) Revenue Act of 1921, §200 (4), (42 Stat. 227; Fed. Stat. Ann. 1921, 123) provided:

> "The term 'paid' for the purposes of deductions and credits under this title, means 'paid or accrued' or 'paid or incurred', and the terms 'paid or incurred' and 'paid or accrued' *shall be construed according to the method of accounting upon the basis of which the net income is computed under §212.*"

The Revenue Acts of 1924 and 1926, §200 (d) (43 Stat. 254, 44 Stat. 10; Fed. Stat. Ann., 1924, 82; 26 U. S. C., §931) provided:

> "*The terms 'paid or incurred' and 'paid or accrued', shall be construed according to the method of*

computing upon the basis of which the net income is computed under §953 or §984. The deductions and credits provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid *or incurred', dependent upon the method of accounting* upon the basis of which the net income is computed under §953 or §984, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

(See Revenue Acts of 1928 and 1932, §§43, 48 (c); 45 Stat. 805, 807; 26 U. S. C., §§2043, 2048; 47 Stat. 185, 187, 26 U. S. C., §§3043, 3048.)

(b) Revenue Acts of 1921, 1924 and 1926, §212 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 133; 43 Stat. 267, Fed. Stat. Ann. 1924, 94; 44 Stat. 23, 26 U. S. C. §953) provided:

"(a) In the case of an individual the term 'net income' means the gross income as defined in section 954 of this title, less the deductions allowed by sections 937 and 955.

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period, (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

(See Revenue Acts of 1928 and 1932, §§21, 41; 45 Stat. 797, 805, 26 U. S. C., §§2021, 2041; 47 Stat. 178, 185, 26 U. S. C., §§3021, 3041.)

(c) Revenue Acts of 1921, 1924 and 1926, §213 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 134; 43 Stat. 267, Fed. Stat. Ann. 1924, 95; 44 Stat. 23, 26 U. S. C., §954), after specifying items included in gross income, provided:

> "The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer *unless, under methods of accounting permitted under subdivision* (b) *of section 953, any such amounts are to be properly accounted for as of a different period.*"
>
> (See Revenue Acts of 1928 and 1932, §42; 45 Stat. 805, 26 U. S. C., §2042; 47 Stat. 185, 26 U. S. C., §3042.)

(d) Revenue Acts of 1921, 1924 and 1926, §214 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 135; 43 Stat. 269, Fed. Stat. Ann. 1924, 97; 44 Stat. 26, 26 U. S. C., §955) provided:

> "(a) In computing the net income there shall be allowed as deductions:
>
> "(1) All the ordinary and necessary expenses paid *or incurred* during the taxable year in carrying on any trade or business, * * *"
>
> (See Revenue Acts of 1928 and 1932, §23; 45 Stat. 799, 26 U. S. C., §2023; 47 Stat. 179, 26 U. S. C., §3023.)

(e) The Regulations involved are set out in Appendix A, pages i to ix below.

V.

STATEMENT OF FACTS.

Edward Brown & Sons.

Before 1923, and during the years here in question, a business of acting as insurance general agent was conducted in San Francisco under the name, Edward Brown & Sons. From 1904, until August 1922, when Herbert H. Brown died, this business was conducted by Arthur M. Brown, the petitioner, and his brother, Herbert H. Brown. After the death of Herbert H. Brown, the business was conducted by Arthur M. Brown alone, until January 1, 1924. On this later date, petitioner's son, Arthur M. Brown, Jr., was admitted as a partner. Thereafter, the business was conducted by petitioner and his son, as partners (R. 56, 125, 130, 131).

The income here in question is from this business. For 1923, it is the income of petitioner doing business as Edward Brown & Sons. For 1925 and 1926 it is petitioner's share of the partnership income of petitioner and his son doing business as Edward Brown & Sons.

Edward Brown & Sons were Pacific Coast General Agent for six fire insurance companies. The relations with four of the companies were defined by writings. Three of these contracts were introduced in evidence, that with the Brand & Lifforsakrings Aktiebolaget Svea (Svea Fire and Life Insurance Company, Ltd., of Gothenburg, Sweden) as petitioner's Exhibit 5 (R. 131, et seq.), that with the Agricultural Insurance Company as petitioner's Exhibit 6 (R. 146, et seq.), and that with the Hudson Insurance Company as petitioner's Exhibit 7 (R. 154, et seq.).

The contract with the United States Merchants & Shippers Insurance Company (known as United States Lloyds) had been lost. It was a copy of the Agricultural contract (R. 165).

The relations with the other two companies, the Hamilton Fire Insurance Company and the Globe & Rutgers Fire Insurance Company, were defined by oral agreement and acts of the parties—conversations and course of dealings. As to them it was agreed commissions should be paid upon net premium writings—gross premiums less cancellations and reinsurance—and that the agent should appoint and cancel agencies, supervise underwritings, endorsements, cancellations, collections, and adjustment of losses, and generally should represent the companies and attend to all of their affairs. The business of all of the companies was conducted in exactly the same way (R. 165, 166).

For the finding of the Board as to the truth of the foregoing see record, page 60.

Functions of a General Agent—Local Agents Distinguished.

Edward Brown & Sons, as general agent, was appointed directly by the companies. The general agent in turn appointed local agents. The duty of the general agent is to manage the company's business and to do its underwriting. The local agent is the solicitor—the man who directly gets the business. (See the statutes set out in Appendix C, pages xiv to xviii.) With this, Edward Brown & Sons, as general agent, had nothing to do (R. 125, 167-169). Any duty with respect to the direct solicita-

tion of business is conspicuous by its absence in the written contracts between the general agent and the companies. For what, then, is the general agent employed? The Board found:

> "The duties required of and performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; received and acknowledged service of proof of loss; issued, countersigned and cancelled policies; received and receipted for premiums, surveyed all risks offered and accepted or rejected the same; represented its principals on the Pacific Board of Fire Underwriters; computed and paid commissions due local agents; ceded or reinsured certain lines of business with treaty or other companies; computed and paid return premiums on cancelled policies; secured return of premium on cancelled reinsurance; rendered all reports required of its principals by the authorities of political subdivisions in the territory in which it operated; attended to the payment of all license fees and taxes; furnished all necessary printed matter, except policy blanks, to local agents; transferred insurance by endorsement; determined whether its principals should participate in special pools; and generally attended to all of the affairs of its principals in the territory in which it operated."
>
> (R. 60, 61.)

The service that Edward Brown & Sons performed was running and operating the whole of the business of the companies which they represented. The contract with the Svea (petitioner's Exhibit 5) in paragraph II expressly appoints Edward Brown & Sons as "general

agents'' for eleven states, two territories and British Columbia, specifies certain duties to be performed and provides that the general agent is ''to transact such other business as usually pertains to a general agency of a fire insurance company''. The agent agrees ''to faithfully perform the duties which usually devolve upon general agents''. The contract with the Agricultural contains almost word for word the same provision. The provision in the Hudson contract, Article II (petitioner's Exhibit 7) is even broader, providing that the agent is ''generally to conduct the business of said company'' in accordance with directions.

In actual practice, as has already been pointed out, all companies were handled alike. The whole of the business was in the hands of Edward Brown & Sons. Nothing was referred back to the home offices (R. 179)—nothing is done in relation to the companies other than to make net remittances to them after all expenses and deductions and losses have been taken from the premium income. No consultation is had with them on any detail, —only on general matters of policy (R. 177-178).

Such service is not related to any particular period in the life of any policy. It extends over the whole of the policy's life. Particularization and examination of the precise services rendered confirm this statement.

The general agent takes all such steps as may be necessary to qualify his company, where it is a foreign corporation, to do an insurance business (R. 168). When the business is first begun, and while he conducts business, he has full ''authority to appoint and remove agents''

(see Exhibits 5, 6, and 7 and R. 169), and of course is charged with the duty of supervision of the local agents. For this the general agent has special employees known as field men (R. 168, 169).

The agents must have necessary forms and stationery. With the exception of the policy blanks and reports of the company, these are furnished by the general agent (R. 168, 169-171). This matter involves considerable responsibility. Riders are used for the purpose of varying and adopting the standard forms of policies to the specific insurance risk. The general agent supervises the supplying and use of these. The form of rider is determined by the Standard Forms Bureau of the Board of Underwriters. This is an organization made up of the standard insurance companies. The companies for whom the general agent acts are represented on that Board by the general agent. The petitioner here, acting for his companies, not only acted on many of the committees of the Board of Underwriters, but was the Chairman of the Standard Forms Bureau (R. 170, 171).

The local agent is not in a position unaided to conduct business. The general agent supplies him with servicing and information service. Field men assist local agents in obtaining business, make surveys, assist them in rating risks, and otherwise do anything that will push the agent's business (R. 169, 170).

When the local agent issues the policy, the general agent must scrutinize it—determine that the correct form, riders, and endorsements have been used, and check the rate. The general agent's functions are different with two

different types of agents. The recording agents, the larger ones who have a thorough knowledge of the business, are permitted to sign policies. There are others, non-recording agents, who are not equipped to issue policies. They send their applications to the general agent where the policies are written. These policies are then returned to the non-recording agent to be countersigned. The compensation of the general agent is the same whether the local agent be a recording or a non-recording agent (R. 170-171).

The policy written, the general agent must and does survey the risk and determines whether or not the risk will be accepted or rejected. This is a matter entirely in the hands of the general agent—it is not referred back to the home office. In practice many risks submitted by local agents are rejected (R. 171).

The next duty is in connection with the collection of the premium. Under its contracts the general agent is given power to "receive and receipt for premiums"; indeed, is obligated to its companies to see that they are paid. It is the general agent's loss if they are not paid (R. 171). It guarantees "the payment to the" insurance company "of all premiums on policies issued by them or their agents" (Exhibit 5, paragraph III; Exhibit 6, paragraph Fifth; Exhibit 7, Article III). The premium must be checked and computed by the general agent and is usually collected within sixty days. The general agent computes and allows for the commission of the local agent after the premium has finally been determined, and makes up the necessary statements in this behalf (R. 171).

When the foregoing services have been completed the insurance has been written and paid for. This does not end the services of the general agent. He has in his hands the matter of reinsurance. If a line or risk written is in excess of what either the company or general agent believes advisable, the liability must be reduced. (See, for example, paragraph IV of Svea contract, petitioner's Exhibit 5; paragraph Sixth of Agricultural contract, petitioner's Exhibit 6.) This can be reduced by reducing the policy, or by insuring part of the excess with other companies. In 99% of the cases reinsurance is effected. There are companies known as "treaties" or "treaty companies". Such a company is simply a reinsurance company for the company which originally writes the risk, and is so called because, by fixed arrangement between the parent company and the treaty, the treaty is entitled to the first line of reinsurance over and above the net line of the parent company. Reference to such treaties will be found in the written contracts introduced in evidence. There is, however, a very large amount of reinsurance that is not controlled by these treaty arrangements. Except for this matter of treaty arrangements the whole matter of reinsurance is in the hands of the general agent. Where there is no treaty the general agent determines both the amount of reinsurance and with whom it is to be placed. Where there is a treaty the general agent must still exercise judgment as to the amount of the reinsurance. The whole matter is in his control—it is not submitted to the companies for their approval (R. 171, 172).

Such reinsurance is effected whenever the particular risk represents an excess. This by no means always occurs when the policy is written. Changes in conditions may create an excess in a risk where there was no excess at the time the risk was first written. Again, a risk may be reinsured in another company and that company cancel. The reinsurance must be replaced. After a policy is written, it may be desirable to get rid of the risk entirely without cancelling the policy; again reinsurance must be effected. This would happen where the company had written a full net line and later a new line, more desirable, and in the same location, would be written (R. 172, 173, where a specific example of this will be found). Sometimes reinsurance is effected with another company represented by the general agent. At other times it is with outside companies (R. 172). Whenever this reinsurance is effected, cancelled, or changed, the general agent is charged with caring for the payment of the premium and the return of the unearned premium. For none of these services connected with reinsurance is the general agent paid any compensation beyond his overriding commission (R. 172, 173). On the contrary, in figuring the net premiums on which his commission is based reinsurance is deducted (R. 166; petitioner's Exhibits 5, 6 and 7). The general agent throughout the life of every policy must be on constant guard to see that the proper reinsurance has been effected, watching not only his own risks but the status of the reinsurance as well.

Reinsurance is a method of changing the company's risk without changing the policy originally written. After

originally written, however, not only may the risk covered by the policy change, necessitating adjustment, but the policy itself may require change. It is done by endorsement. An example of this would be where property is sold and the insurance is transferred by endorsement. Other changes of this nature will suggest themselves. No further compensation is paid for this service.

The matter does not stop with the endorsement. The endorsement may affect the rate. It may decrease the rate, in which event the general agent must refund part of his overriding commission. This costs him money. It is possible that the rate may be increased. In this case the general agent obtains overriding commission upon the increase. *This is the only time where, after a policy is originally written, the compensation of the general agent is changed by the receipt of further compensation* (R. 175, 176). And all of the mechanics which must be gone over in the case of the original writing of a policy, must be gone over for each of these changes—that is, the checking, computation, collection, remittances and reinsurance (R. 176).

Two other things may happen, after the policy is written, matters of loss aside for the moment. The policy may be cancelled. Unearned premium must then be returned. This matter is handled by the general agent, using his own funds. This will be referred to again. Reinsurance may be cancelled. This is wholly controlled by the general agent (R. 176).

In the event of a loss, the general agent has important duties. The written contracts expressly authorize him

"to receive and acknowledge service of proof of loss", "to adjust losses under the policies" of the companies, and in the event of litigation, "to accept service of process" (petitioner's Exhibits 5, 6 and 7). All technical requirements must be handled. All of the papers scrutinized. Investigation of the loss must be made. At times this requires months. The general agent determines what losses shall be paid. These matters are not referred to the companies. The agent determines whether in the event of litigation he will continue to refuse to pay. In the event of litigation he controls it on behalf of his companies. They bear the legal expenses but the agent receives no further compensation for his own services (R. 177).

No suggestion is required to point out the important and delicate function the general agent performs in handling losses. Not only must he protect his companies, so far as the assured is concerned, but it of course devolves upon him, when a loss has been paid, to see to it that collection is made from companies which have reinsured part of the risk, and, where possible, to recoup any salvage. The mere suggestion that the general agent has in charge the handling of losses will indicate the very minute, painstaking, thorough-going, untiring service which he performs.

So far we have been dealing with services which may be said to be on the assured's side of the handling of insurance. There are further services to be performed upon the company's side.

Supervision of the local agents has been suggested. As pointed out in the written contracts with the com-

panies, the local agents are required to report their business to the general agent. These reports must be checked and digested. The general agent must then promptly forward to the home office "bordereaux" of risks written, endorsements, changes upon policies, all changes in agents or risks, and all other matters, particularly losses. The Hudson contract required weekly reports. One of these bordereaux, covering only premiums and return premiums (R. 190) for one company, for three months, was produced before the Board showing the nature of the reports made and the meticulous care and detail required (R. 173, 174, 175). Without extra compensation a statistical department is maintained (R. 175). The significance of such a department needs no comment.

Not only must reports be made to the companies but municipal, state and federal authorities require reports. These are made by the general agent (R. 175, 176). All matters of local license, taxes, and things of that sort, with the exception of the fact that two of the companies pay the state taxes directly, are handled by the general agent (R. 175).

The most important function performed by the general agent, which requires continued, intensive and exhaustive effort, is the constant checking of all risks within the territory. He must keep himself so informed that he can intelligently determine whether or not a risk shall be accepted. He must carefully watch all classes of risks in all localities, to determine whether or not business continues to be profitable, once it has been written. If conditions change liability can be ended. The companies

have no control over this (R. 176, 177). The general agent employs and sends out engineers and field men to inspect the risks. Markets and general conditions are watched; new buildings and changed physical conditions must be investigated and checked. Maps of the whole territory are kept in detail, by blocks for every city and town of any importance. Moral and financial standing of the assured is investigated and to this end the general agent is a member of credit rating bureaus.

Akin to this service, because it depends upon the nature of the risk, is the fixing of rates. This is done by the Board of Underwriters. The agent represents his company on this Board.

There are risks which a single company cannot insure. Pools are formed. The participation in such pools is in the hands of the general agent (R. 178-9).

In a word, the general agent handles the whole of the business of the company in his territory (See *Vance, Insurance,* 2 ed. 416). This, in the case of Edward Brown & Sons, was so much so that it required an investment of $250,000 for them to run the business of their companies. On occasions they have had to pay losses out of their own funds and borrow money to operate their companies (R. 178). Edward Brown & Sons were not reimbursed by the companies for interest paid—they received only the original commission paid.

The general agent is a wholesaler of insurance. In a given territory he is the manager of his companies. The local agent is the solicitor of insurance. When the local

agent procures the business and the policy is written, his functions end. It is at this point that the general agent's functions begin. At every moment while a policy is current he has duties as to that policy—his functions are performed throughout the life of the policies and are referable to the policies in force. The existence of outstanding policies is the only justification for the general agent.

Compensation Paid to Agents—General Agents and Local Agents Distinguished.

The compensation of the local agent is a policy commission, or commission for getting business. It is fixed by an independent organization, the Board of Underwriters (R. 126).

Edward Brown & Sons operated not only in California but in other western states, British Columbia, Alaska, Territory of Hawaii, and the Philippine Islands. (See Exhibits 5, 6, and 7, and as to the Globe & Rutgers and the Hamilton see R. 166, 167.) In many of these places statutes required that all policies be signed by a local *resident* agent. In some instances it was expressly provided that he should "receive the full commission when the premium is paid".

Idaho, Compiled Statutes, §5009, Statutes of 1915, Chapter 145, §2, p. 318, (R. 167);

California, Political Code, §633d;

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§149, 160, 183-186, 197;

Nevada Revised Laws, §1304, as amended by Statutes 1919, 392;

Montana Code, §6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29;

Wyoming, Insurance Laws, §11, Laws, 1921, Chapter 142, §3;

Oregon, Insurance Laws, §4, Olson, Oregon Laws, §6333, Laws 1923, Chapter 115, §1, p. 172.

Excerpts from these statutes are set out in Appendix C. This enumeration is not exhaustive.

Whether such statutes were in force or not, the same rule was followed by Edward Brown & Sons. In all cases a local agent received the policy commission (R. 167, 168).

The compensation of Edward Brown & Sons was fixed by the contract with the companies. The general agent received a contingent "commission"—a percentage of net earnings, if any, on the business written through the general agent—and an "overriding commission"—that is, a percentage of the premium over and above, and irrespective of, the commission paid to any local agent (R. 126). The overriding commission is a percentage of the *net* premiums on business written through the general agent. Net premiums are gross premiums, less cancellations (by the company or by the assured), and less net reinsurance effected (R. 246, 247, 257, 166, and Exhibits 5, 6, and 7). The general agent made monthly remittances of the premiums for which he was accountable, less commissions allowed, including his own overriding commission.

No question arises here with respect to the contingent commission.

Return Commission.

All policies issued through Edward Brown & Sons were cancellable at the option of the assured, "short-rate," or at the option of the company, on pro rata repayment of the unearned premium. The forms of policies used were introduced as petitioner's Exhibits 1 and 2. No form for British Columbia was available, but cancellation there is covered by subdivision 10 of §142 of the Insurance Act. This was read into the record (R. 124). The forms in many states are fixed by statute:

California: Statute 1909, p. 404; Deering, General Laws (1923), Act 3735;

Oregon: Olson's Laws, §6458; L. 1911, c. 175 §1, p. 279. See for special provisions as to cancellation, Insurance Laws, §22-i; L. 1917, c. 203; §22-i, p. 362; Olson's Laws, §6394;

Hawaii: Revised Laws 1925, §3451;

British Col.: Insurance Act, supra, §142;

Idaho: Comp. Stats., §5053;

Wyoming: Insurance Code, §95, L. 1921, Ch. 142, §18.

The foregoing enumeration is not exhaustive.

The New York Standard Form is the basis for all forms of fire policies. Its provision for cancellation is as follows:

> "This policy shall be cancelled at any time at the request of the insured; or by the company by giving five days' notice of such cancellation. If this policy

shall be cancelled as hereinbefore provided, or become void or cease, the premium having been actually paid, the unearned portion shall be returned on surrender of this policy or last renewal, this company retaining the customary short rate; except that when this policy is cancelled by this company by giving notice it shall retain only the pro rata premium."

This privilege of cancellation has an immediate and important effect upon the compensation paid the general agent. *Whenever there is a cancellation and a return of a portion of the premium the general agent must return a corresponding portion of his commission.* It is this consideration which ties the time element into the earning of his overriding commission. That commission is directly related to the life of the policy, because, on cancellation of the policy, a proportionate refund must be made, and because the compensation is for services, as indicated, running over the life of the policy.

This results because overriding commission is figured on *net* premiums. Net premiums result only after cancellations and reinsurance have been deducted. (See Exhibit 5, par. V; Exhibit 6, par. Seventh; Exhibit 7, Art. VI. Compare the special exceptions stated in the event of a rate war and cancellations through general reduction of rates—Exhibit 5, par. VII, Exhibit 6, par. Ninth, Exhibit 7, Art. X). The Hudson contract had an express provision on the subject (Exhibit 7, Art. III). An express provision is not necessary, however, where commission is a percentage of *net* premiums. As a matter of law the commission is not fixed until all cancellations

and reinsurance have been determined. If the agent has been overpaid he must make refund even though the cancellations are effected after termination of the agency.

Milwaukee Mechanics Ins. Co., v. Warren, 150 Cal. 346;

National Union Fire Ins. Co., v. Nason, 21 Cal. App. 297.

So long as the agency continues, the necessary adjustments are made by appropriate entries in arriving at the amount due on periodic settlements. This is not so after the agency ends. Edward Brown & Sons, between 1923 and 1926, had an experience which brought them within these California cases. Their agency for United States Merchants & Shippers Insurance Company was terminated. They were required to, and actually did, repay portions of commissions received by them but related to the unearned portion of premiums on policies cancelled (R. 179).

The overriding commission of the general agent is only a percentage of the premium income of the company. Like that premium income, it is earned only over the life of the policy. If the policy is prematurely terminated, a proportionate and proper refund must be made. This is known as "return commission".

From long experience, the ratio of cancellations to business written can be predicted, and the relation of return commission to gross commission received accurately fixed. Edward Brown & Sons' own experience showed the proportion of overriding commission on business written

in any year (whether for one, three or five years), of which return would have to be made.

Five Year Period	Gross Fire Premiums Written	Fire Premiums Cancelled	Ratio
1919 to 1923	$14,893,022	$3,333,104	22.38%
1920 to 1924	15,647,482	3,492,101	22.32
1921 to 1925	15,931,443	3,432,670	21.55
1922 to 1926	17,155,359	3,642,071	21.13

(Petitioner's Exhibits Nos. 28-32.)

In the fire insurance business, generally, cancellations run from 20% to 25% (R. 206).

It will be noticed that the percentage of cancellations is arrived at by using five year periods. Compare Treasury Regulations, Art. 91 (Appendix A, p. vi), dealing with redemption of trading stamps.

Methods of Accounting and Making Return.

The books of Edward Brown & Sons were kept on the accrual basis (R. 195, 251, 257). The Board so found (R. 63). This is the standard and accepted method for insurance general agents (R. 251). The method of accounting has never been changed. The methods of return hereafter noticed, however they may differ, required no change in method of keeping the books, nor the changing of any figure on those books (R. 201, 211, 250-252).

The policies written through Edward Brown & Sons were written for one, three, and five years. The exact proportion of each is shown by Exhibits 22, 23, 24, and 27. Accordingly, cancellations took place in years other than the year in which the policy was issued.

Until 1923 return of overriding commission was made by returning overriding commission shown on the books for any one year, less return commission on cancellations effected in that year. This resulted in charging against overriding commission shown for one year on business written in that year, and from premiums accounted for in that year return commission, returned in that year, on cancellation of business written in an earlier year, where the commission, a part of which was returned, was shown for the earlier year as from a premium accounted for in an earlier year. *Under this method return commissions were charged, not against the commissions and the year to which the same related, but against later years.* In the case of return commission relating to policies written for the United States Merchants & Shippers Insurance Company, after termination of the agency for that company, such method would charge return commission, not against that company and the policies to which the same related, but against commissions received on different policies written for wholly different companies.

For 1923, the first year in which petitioner was sole proprietor of the business, conceiving that this method was inaccurate, and that the return commission should be charged against the very commissions which were being returned, and as a charge properly attributable to the process of earning those commisisons, during the period in which they were received (cf. *U. S. v. Anderson*, 269 U. S. 422, 70 L. ed. 347 and Reg. 62, Art. 111, Reg. 74 and 77 Art. 342), petitioner set up a figure on his books (Petitioner's Exhibit No. 31), dictated by past experience

as to cancellations and return commission (page 26 above), representing the liability to return commission, by reason of future cancellations of 1923 business. This was deducted from the commission shown for 1923 in making return. This method was followed for subsequent years.

In making his return in this way, the petitioner did not change the method of accounting. The same method was continued in use in keeping the books. No entries on the books were changed. The figures used are those which appear on the books. The books were kept on the same theory as was used in computing and showing the true income of petitioner. The only thing that was done was to bring the system more nearly in accord with the accrual method by perfecting the system. The returns were made in accordance with the books, and on the same basis as that upon which the books had been kept (R. 201, 211, 232-234, 250-252, 257).

Under this method return commission on account of cancellation of policies written in 1923, where cancellations occurred in later years, was charged, not against commissions received on other policies, written in the year of cancellation, but against this reserve so set up, and since this reserve was charged against commissions on the policies now cancelled, it was charged against the policies and commissions to which it in truth related. This procedure was followed for later years.

This figure so set up and charged—this reserve—was $52,971.96, for 1923. The net additions to the reserve for 1925 and 1926 were $3,292.98 and $1,947.77. These are the figures in dispute. Their disallowance gave rise to

the deficiencies assessed (R. 245-247, Exhibits 14, 15, 16, and 32).

Before the Board petitioner urged, and now urges, a third method suggested by acts of Congress. This is a method of strict actuarial computation, showing when the commissions were earned and returning them only as earned. This method is to return in each year only the compensation earned in that year, computed not by taking commissions shown on the books, less a figure representing the obligation to return part of it on cancellation of policies, which figure is determined from experience, but by taking the actual policies in force in a given year (whether written in that year or not), computing the premiums earned in the year, and so arriving at the compensation earned in that year. This method prorates the commission over the life of each policy, and as it is earned. Exhibits giving the figures on this basis are in evidence (Exhibits 20-28).

This last method, and the method used in making the return, were disallowed. The Commissioner required the petitioner to return his income in accordance with the method used before 1923, with resulting deficiencies. The commission coming in was accounted for under the accrual method—it was shown on the books as the business was written and as the premiums were shown, whether actually collected or not. The Commissioner permitted deduction for "return commission," going out, only as return was actually made. *Thus, the commission coming in is shown on the accrual basis, but the outgo of return commission the respondent insists petitioner shall show on a cash basis.*

VI

SPECIFICATION OF ERRORS.

The court below erred in affirming orders of the Board of Tax Appeals determining any deficiency as to tax due from petitioner on his income for the years 1923, 1925, and 1926 (except as any deficiency may have been assessable for 1923, because of deduction of $3,000 paid to Mrs. Halton, a matter now foreclosed to us), and erred in failing to find that there was no deficiency in the income tax of petitioner for these years. The court erred in affirming orders of the Board of Tax Appeals, charging back to petitioner sums deducted by him as reserve against his liability to refund return commissions, being $52,971.96 for 1923, $3,292.98, partnership income for 1925, and $1,947.77, partnership income for 1926.

The court below erred in affirming orders which compel petitioner to return "return overriding commission" income on a cash disbursement basis, while the books, and particularly the income of overriding commission, were on an accrual basis, and where the accrual basis was "the method of accounting regularly employed in keeping the books."

The court below erred in refusing to permit petitioner to return overriding commission income on an accrual basis, and on such basis to compute it either:

(a) By returning overriding commission income shown on the books for any given year, less an amount, ascertainable on the basis of past experience, representing the liability coincidentally incurred to return a part of this overriding commission on

cancellation of policies to which the same related; or, in the alternative,

(b) By returning overriding commission income only as earned, on a strict actuarial basis.

The court erred in holding that income shown (whether received or not) on books kept under the accrual method is at once subject to the taxpayer's disposition, and so must be returned in the year in which entered on the books, and that the methods suggested by petitioner are only methods of returning at some indefinite future time of petitioner's own selection; that the figures set as reserves and here in question are to cover contingent liabilities; that such figures are not authorized as deductions, and that such figures, arrived at as the figures here were fixed, on the basis of experience are not countenanced as proper subtractions, under the statutes, even where the books are kept on an accrual basis. The court erred in determining that overriding commission was earned when first shown on the books, and not over the lives of the policies to which it was related, and must be returned in the year when so shown, though the books were kept on an accrual basis, though some of it would have to be returned, and though only part of the services for which the same was payment were performed in the year in question. (See record pages 86 et seq., 97 et seq. and 108 et seq.)

VII.

SUMMARY OF ARGUMENT.

Income taxes are imposed for annual periods. Return must be made so as to truly reflect income for each such

period. To this end the statutes have been amended from time to time, particularly to permit the use of the accrual method of accounting. As the result there are two, and only two, methods which can be used—the cash receipt and disbursement method, and the accrual method. Whichever of these methods is selected by the taxpayer as the method for keeping his books must be consistently followed assessing his income tax. This elementary principle was violated by the reassessment made against the petitioner. His books were on an accrual basis, but he was required to treat certain items—return commissions —on a cash disbursement basis.

The purpose of the change in statutes was to permit taxpayers to keep their books and make their return according to scientific accounting principles, by charging against the receivables for a given annual period the expenses incurred in that period and properly attributable to it. There were two methods which could be used here to attain this purpose—(a) by returning gross commissions shown on the books, less a reserve on account of liability to refund a part of that on cancellation of policies to which the same related, or (b) by prorating the commission over the life of the policies to which the same related, and returning it on a strict actuarial basis as earned. Both of these methods are sanctioned by good accounting practice and by the statutes as construed by this court. Both will clearly reflect taxable income. The petitioner should be permitted to use one or the other, although it is submitted that the second method represents the better accounting practice.

VIII.

ARGUMENT.

Under the income tax statutes, gains and losses for tax purposes are computed for annual periods.

> "The scheme of the Revenue Act is an imposition of tax for annual periods, and the exaction for one year is distinct from that for any other."
>
> *Tait v. Western Maryland Ry. Co.*, ...U. S....., 77 L. ed. 906, Adv. Op., Oct. Term 1932, No. 842.

Gains are to be accounted for when realized (whether paid or not), and deductions taken in the year in which sustained—"paid or incurred".

Tait v. Western Maryland Ry. Co., supra;

Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 75 L. ed. 1049;

Burnet v. Sanford & Brooks Co., 282 U. S. 359, 364, 365, 75 L. ed. 383, 387;

Lucas v. Kansas City Structural Steel Co., 281 U. S. 264, 268, 74 L. ed. 848, 851;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;

Reg. 62, 65 and 69, Art. 22, Appendix A, p. ii.

We believe, with deference, that this elementary principle was lost sight of below.

In making a return for any annual period, the basic rule is that return shall be made in such a way as to clearly reflect taxable income. To this end, the Revenue Acts have been amended from time to time. These amendments have immediate bearing on the matter at hand.

History of the Statutory Provisions Involved.

The prototypes of the income tax statutes were the Corporation Excise Tax Act of Aug. 5, 1909 (chap. 6, 36 Stat. 11, 112) and the Corporation Income Tax Act of Oct. 3, 1913 (chap 16, §II, subd. G, 38 Stat. 114, 172). These statutes made no provision for the accrual system of accounting. Though some necessary departures were permitted (see *Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297), the general scheme was of a return on a cash receipts and disbursements basis (*U. S. v. Anderson*, 269 U. S. 422, 438, 70 L. ed. 347, 350.) The statutes did not in terms permit deduction of accounts payable, nor provide for the use of inventories. (*Aluminum Castings Co. v. Routzahn*, 282 U. S. 92, 96-97, 75 L. ed. 234, 236.)

Such a scheme could not work. Necessity required that the Treasury Department issue regulations under which inventories and accounts receivable and accounts payable could be drawn into the calculations. What has been called a mongrel system of accounting and return grew up. By 1916 the situation compelled the attention of Congress. In dealing with the problem in the Revenue Act of 1916 the Committee on Ways and Means (House Report, No. 922, 64th Cong., 1st Sess., p. 4) reported:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipts basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income."

The Revenue Act of 1916, §§8(g) and 13(d) (39 Stat. 756, 761, 770) authorized taxpayers "keeping accounts on any basis other than that of actual receipts and disbursements" to make return on such basis. Notwithstanding this option it was "the purpose of the Act to require returns that clearly reflect taxable income" (*U. S. v. Mitchell*, 271 U. S. 9, 12, 70 L. ed. 799, 801). Even under this Act, it has been held "that the return must be filed on the accrual basis" "where true income can not be arrived at on the basis of actual receipts and disbursements" (*Aluminum Castings Co. v. Routzahn*, supra).

The Treasury Department, on January 8, 1917, issued new regulations under the Revenue Act of 1916. (Treasury Decision 2433, Appendix B, pp. x to xiii.) These were held in *U. S. v. Anderson*, 269 U. S. 422, 438, 70 L. ed. 347, 350, to be a correct interpretation of the Act, "consistent with its purpose and intent", and "in harmony" with §13(d). (See Appendix B, p. xiii.) Then by the Revenue Act of 1918 (Feb. 24, 1919, chap. 18, 40 Stat. at L. 1058, 1064, §§200, 212) it was made mandatory for taxpayers to use their bookkeeping basis as the basis for making return. A provision like that in the Revenue Act of 1918 is found in all of the later acts. The effect was to introduce the accrual method of accounting as a basis for making return.

Niles Bement Pond Co. v. U. S., 281 U. S. 357, 74 L. ed. 901;

Aluminum Castings Co. v. Routzahn, 24 F. (2d) 230; 31 F. (2d) 669 (C. C. A. 6); 282 U. S. 92, 75 L. ed. 234.

"The regulations of the Treasury under all the Revenue Acts since 1916 have required taxpayers to report on the cash or accrual basis, depending on which method was pursued in their accounting. Since the adoption of the Revenue Act of 1921 (1918?) the requirement has been statutory. It is settled beyond cavil that taxpayers other than insurance companies may not accrue receipts and treat expenditures on a cash basis, or vice versa. Nor may they accrue a portion of income and deal with the remainder on a cash basis, nor take deductions partly on one and partly on the other basis."

Mass. M. L. Ins. Co. v. U. S., 288 U. S. 269, 77 L. ed. 435 (Adv. Op., Oct. Term 1932, No. 322).

The statutory change sanctioned the use of induction in accounting for tax purposes, within such limits as were fixed by good accounting practice.

The result is that "prior to the Act of 1926 the Revenue Acts definitely recognized only two bases for tax returns—cash and accrual". (*Burnet v. S. & L. Bldg. Corp.*, 288 U. S. 406, 77 L. ed. 617—Adv. Op., Oct. Term 1932, No. 475.) The changes from 1926 on do not affect the foregoing generalization, so far as this case is concerned.

At about the time the question of proper accounting methods for tax purposes was being considered by the Treasury Department and by Congress—consideration reflected in the Acts of 1916 and 1918—the same question was being agitated before the American Institute of Accountants, the Federal Trade Commission, and the Federal Reserve Board. This led to the issuance of a bulletin by the Federal Reserve Board, in April 1917. (See Appendix

D, p. xix.) Excerpts from a revised edition of this bulletin are set out in Appendix D. This bulletin represents the best in modern accounting practice. It calls for accounting on the accrual basis, and goes beyond any position which it is necessary for the petitioner to take in this case.

Under the later Revenue Acts the Treasury Department issued revised regulations. The parts of these regulations referable to the sections of the Revenue Acts of 1921, 1924 and 1926 here involved are set out in Appendix A. The re-enactment of these sections of the earlier acts indicates that Congress has recognized and adopted the established practice of the Department in the interpretation and application of such sections. These regulations have had congressional approval.*

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;
Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 75 L. ed. 1049;
Old Colony R. Co. v. Com'r of Int. Rev., 284 U. S. 552, 76 L. ed. 484;
Murphy Oil Co. v. Burnet, 287 U. S. 299, 77 L. ed. 168 (Adv. Op., Oct. Term 1932, No. 80);
Mass. M. L. Ins. Co. v. U. S., supra, p. 36.

Effect of Revenue Acts—Accounting Method Used Must be Followed Consistently—Respondent Neglected this Rule.

To properly fix the scope and effect of the provisions of the Revenue Acts their purpose must be borne in mind.

*NOTE: In this regard it is to be remembered that all the regulations set out in Appendix A had their prototypes in the same numbered Articles in Regulations 45 issued under the Revenue Act of 1918, except Art. 51 in Reg. 62 was Art. 52 in Reg. 45; Art. 91 in Reg. 62 was Art. 88 in Reg. 45; Reg. 45 contained no Article like Art. 155 of Reg. 62.

In dealing with the purpose of the prototype in the Act of 1916, of the sections here involved, it was said:

> "It was to enable taxpayers to keep their books and make their returns *according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;* • • •.
>
> *"The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year.* The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained."

U. S. v. Anderson, 269 U. S. 422, 440, 70 L. ed. 347, 350, quoted in

American National Co. v. U. S., 274 U. S. 99, 104, 71 L. ed. 946, 949;

Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234;

Miller & Vidor Lumber Co. v. Commissioner, 39 F. (2d) 890 (C. C. A. 5), cert. den., 282 U. S. 864, 75 L. ed. 764.

This purpose is attained by the provision that the return shall be made "in accordance with the method of account-

ing regularly employed in keeping the books". For petitioner there were only two methods open—the cash receipts and disbursement method and the accrual method. (*Burnet v. S. & L. Bldg. Corp.*, supra, p. 36.) These two methods are mutually exclusive.

> "It is settled beyond cavil that taxpayers other than insurance companies may not accrue receipts and treat expenditures on a cash basis, or vice versa. Nor may they accrue a portion of income and deal with the remainder on a cash basis, nor take deductions partly on one and partly on the other basis."
>
> *Mass M. L. Ins. Co. v. U. S.*, supra, p. 36.

Accord:

U. S. v. Anderson, supra;

Niles Bement Pond Co. v. U. S., 281 U. S. 357, 359; 74 L. ed. 901, 903, quoting T. D. 2433;

Aluminum Castings Co. Routzahn, 282 U. S. 92, 75 L. ed. 234, quoting T. D. 2433;

See: T. D. 2433, Appendix B, p. xii.

Our position is that which the Government successfully maintained in *Aluminum Castings Co. v. Routzahn*, supra. In the Government's brief Solicitor General Thacher expressed the position as follows:

> "In order that income may be clearly reflected, it is necessary where income is computed on the accrual basis that all items, both of receipts and disbursements, must be consistently included when accrued, whether paid or received or not. This plain economic fact has been asserted in the administrative regulations of the Treasury Department, the validity

of which has been recognized in the decisions of this court.

* * * * * * * * * *

"This court has recognized the fact that if a return is on the accrual basis all items, both of receipts and disbursements, must be included as they accrue, if the return is to reflect income clearly."

This general proposition, without more, makes the respondent's action unjustifiable. The books were kept on the accrual basis. Income was shown, not as received, but as it accrued. "Pecuniary obligations payable to or by the company were treated as if discharged when incurred." (*U. S. v. American Can Co.*, 280 U. S. 412, 74 L. ed. 518.) The taxpayer endeavored to treat a consistently recurring item of outgo so that this item, and the commission coming in, would be handled in accordance with the dominant method used, and the taxable income as a whole shown on a basis in harmony with the accrual method of keeping the books. The attempt at consistency is resisted by the Commissioner. He insists that the item of return commission be treated on a cash basis.

The method used by the commissioner does not have the element of consistent treatment of all items, which is required. It is out of harmony with the bookkeeping method, and erroneous under the settled construction of the statutes.

It remains only to consider whether or not there is any possible method of return adaptable to the facts here, which is in harmony with the Revenues Act, i. e. is in harmony with the accrual method "regularly employed

in keeping the books", and which will truly reflect income. Two such methods exist.

Proper Methods of Return.

The two methods of return, possible here, have received congressional and accounting approval. The first is a strict actuarial method; accruing overriding commission income, by prorating the income over the life of the policies; "deferring" unearned income. The second is by showing overriding commission income as of the time it should be received, and finding income for tax purposes by deducting the liability, which inhered in that receivable, to return part of it on cancellation of policies; deducting "accrued" or "incurred" liability. It is believed that the first of these two methods is the more accurate. Historically, the other came first, and we take it up first, after noticing some general considerations.

(a) Raising revenue is a practical matter. Congress has handled it in an eminently practical way. The statutes have not been burdened by detailed requirements in an endeavor to anticipate the factualities of commercial life. The whole matter is treated by referring it to the bookkeeping method which the taxpayer has adapted to his business needs. The statutes use plain language. That language is to be given its ordinary meaning. (*U. S. v. Kirby Lumber Co.*, 284 U. S. 1, 76 L. ed. 131; *Old Colony R. R. Co. v. Com'r of Int. Rev.*, 284 U. S. 552, 76 L. ed. 484.)

The test in handling any particular item, is itself to be practical. For example, "the requirement that losses be deducted in the year in which they are sustained calls for a practical test". (*Burnet v. Huff*, 288 U. S. 156, 77 L. ed.

478—Adv. Op., Oct. Term 1932, No. 58.) In *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 538, this court expressly distinguished; said that the time as of which an item should be accounted for called "for a practical, *not a legal,* test".

Revenue requirements may color this practical test. But it still remains that the problem is solved primarily by considering the business significance of the factual elements. The Treasury Regulations recognize this. The regulations are valid

> "unless unreasonable or inconsistent with the statute. They constitute contemporaneous construction by those charged with the administration of the act, are for that reason entitled to respectful consideration, and will not be overruled except for weighty reasons."
>
> *Fawcus Machine Co. v. U. S.*, 282 U. S. 375, 75 L. ed. 397.

The regulations pertinent here (Appendix A) have received congressional approval by the re-enactment, without substantial change, of the sections of the statute to which they are referable. (See p. 37 above.)

Art. 21 (Appendix A, p. ii):

> "*Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income'.* This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer."

Art. 22 (Appendix A, p. ii):

"The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. *If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.*"

Art. 23 (Appendix A, p. iii):

"*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.* A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See Section 200 of the statute for definitions of 'paid,' 'paid or accrued,' and 'paid or incurred'."

Art. 24 (Appendix A, p. iv):

"*It is recognized that no uniform method of account can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in* HIS *judgment best suited to his purpose.*"

Art. 51 (Appendix A, p. v):

"Gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, *unless they are included when they accrue to him in accordance with the approved method of accounting followed by him.*"

Art. 111 (Appendix A, p. vii):

> "Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, * * *. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year."

When the books of Edward Brown & Sons showed that they were entitled to collect a given amount of commission they did not show that that commission had been collected —the books were on an accrual basis, and commission showed as a receivable, whether received or not. Even if received, it was not gain or profit at its face amount. As a matter of business fact its value was reduced by the obligation concurrently incurred to return a part of it on cancellation of policies. A part of it had to be held available to meet this obligation. This was a matter of business necessity—a prerequisite to continued business life—as well a matter of legal necessity. The contract of the general agent with the companies presupposed and was bottomed on the ability of the general agent to meet this obligation. (2 *Corpus Juris*, 546, §178; 2 *Williston, Contracts*, §880.) The statutes and Regulations, where the books were on the accrual basis, require that this situation be reflected.

As to any particular policy, cancellation depended on a choice of the assured or the company. So far as the obligation of the agent was concerned, it is to be noticed, however, that the happening of this condition, as to any particular policy, was a matter wholly beyond his control. But income taxes are not fixed by consideration of individual items.

"All the revenue acts which have been enacted since the adoption of the 16th Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of *all* the taxpayer's transactions during a fixed accounting period * * *."

Burnet v. Sanford & Brooks Co., 282 U. S. 359, 363, 75 L. ed. 383, 386;

Virginia-Lincoln Furniture Corp. v. Com'r of Int. Rev., 56 F. (2d) 1028—C. C. A. 4.

There is no contingency when the whole of the general agent's business is looked at. As to *him* there was no uncertainty. There was no contingency "in the economic and bookkeeping sense with which the statute" is concerned.

That the item of return commission is properly referable to the year in which the cancelled policy was written, and that it is a charge "incurred in and properly attributable to the process of earning income during that period" is demonstrated by a simple example. Part of overriding commission for business written in 1923 will be returned. On this part no tax is to be paid. Assume part of this is returned in 1924, and that the agency for the company terminated December 31, 1923. If the taxpayer has gone out of business from what is this return to be deducted? If it can be deducted only for the year in which it is returned, and if he then has no income, it avails him nothing; and he has been forced to pay a tax on something which was not a gain or profit to him. If he is to get the benefit of this by filing an amended return for 1923, *then it is because this item is referable to 1923*, and, since on the basis of past experience, its amount could have been fixed with reasonable certainty in 1923, it should have been de-

ducted from 1923 receivables in the first instance! (*Cf.*, *Continental Tie & Lumber Co. v. U. S.*, infra, p. 50).

In actual fact the agency of Edward Brown & Sons for Merchants & Shippers terminated during the years in question. After that termination commission was returned. The respondent is now asking that this return commission be charged against commission received after this termination and related to different policies written for different companies!

The gross receivables, shown on the books of the general agent for a particular year, are not gain or profit to him. Under the accrual method he can show this in two ways. He can show the gross amount of such receivables, less the figure representing the factual and legal obligation to return a part of them; less a reserve for deferred charges. Or he can show these receivables only as earned, by deducting from the gross the part representing unearned and deferred income.

(b) Authority to return the income by showing overriding commission less a reserve for return commission is found in T. D. 2433 (Appendix B—see p. 35 above), as a construction of the Revenue Act of 1916 which followed the provision it construed into the perpetuating sections of the acts of 1921, 1924 and 1926. T. D. 2433 ruled that

> "it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals *approximate as nearly as possible* the actual liabilities for which the accruals are made, * * *.

"In cases wherein, pursuant to the consistent practice of accounting * * * corporations set up and maintain reserves to meet liabilities, *the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred,* it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; * * *."

There is ample accounting authority for this ruling:

Federal Reserve Board Bulletin, "Verification of Financial Statements" (Appendix D, p. xix);

Montgomery, Auditing Theory and Practice (Appendix E, p. xxix);

Montgomery, Federal Tax Handbook, pp. 8 and 9, 14 and 15, 17-21, 21 and 22 (Appendix E, pp. xxx-xxxv);

Finney, Principles of Accounting (Appendix E, p. xxxvi);

Lough, Business Finance (Appendix E, p. xxxvii).

Speaking of T. D. 2433, this court said in *U. S. v. Anderson,* 269 U. S. 422, 439, 70 L. ed. 347, 350:

"It recognized the right of the corporation to deduct all accruals and reserves, *without distinction,* made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income."

Return commission meets the test of a deductible liability within the authorities. It is no answer that there may be uncertainty as to particular items. For income tax purposes the items are to be dealt with as a whole. When so dealt with there is no uncertainty. It is no answer that as to a particular item there is no present liability which can be enforced in an action at law. The test is not a legal test—the test is not the ability to draw and maintain a declaration. If it were *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 538, must have been decided differently. The test is a practical one. As a matter of business actuality there is no difference between the paying of return commission here and the paying of the "guaranty" in the *American National Company Case*, infra. Whatever was present on the face of the agreements in that case and may not be so expressed here, is here supplied by a permissible process of induction. It is enough that there is a liability reasonably imminent, beyond the control of the taxpayer to change, the amount of which can be foretold with reasonable accuracy.

U. S. v. Anderson, supra;
American National Co. v. U. S., 274 U. S. 99, 71 L. ed. 946;
Lucas v. American Code Co., supra;
Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111.

In *U. S. v. Anderson*, supra, it was held that a tax which was not due and payable until 1917 was deductible as accrued in 1916. This court called to attention the part of T. D. 2433 quoted above at pages 46-47, and then, after using the language quoted at pages 35, 38 and 47 said:

> "*In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the tax had accrued.* It should be noted that §13(d) makes no use of the word 'accrue' or 'accrual' but merely provides for a return upon the basis upon which the taxpayers accounts are kept, if it reflects income—which is precisely the return insisted upon by the Government."

American National Co. v. U. S., supra, involved the question of deduction for a liability assumed to pay purchasers of notes 1% per annum for the life of the loan, which in each case was more than a year. It was held that this undertaking was an expense of sale of the loan notes; that:

> "The company's net income for the year could not have been rightly determined without deducting from the gross income reported by the commission notes, the obligations which it incurred under the bonus contracts, and would not have been accurately shown by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected true income. And, just as the aggregate amount of the commission note was properly included in its gross income for the year —although not due and payable until the expiration of two years—so, under the doctrine of the Anderson Case, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not 'accrue' in that year in the sense of becoming then due and payable."

Lucas v. American Code Co., supra, presented the question of the deductibility of a "reserve" against liability for claimed breach of contract, where the taxpayer "denied

and strenuously contested" the asserted liability, and where the claimed reserve "had no relation to the apprehend total loss." The claimed deduction was, naturally, disallowed. In the course of its discussion the court said:

> "Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. Exception is made, however, in the case of losses which are *so reasonably certain in fact and ascertainable in amount* as to justify their deduction, in certain circumstances, before they are absolutely realized. * * * It may be assumed that, since the company kept its books on the accrual basis, the mere fact that the exact amount of the liability had not been definitely fixed in 1919 would not prevent the deduction, as a loss of that year, of the amount later paid."

In *Continental Tie & Lumber Co. v. U. S.*, supra, the question was as to the time of showing an amount to be received by a railroad from the Government and to be fixed by the Interstate Commerce Commission. It was held that it should be drawn into the account for the year when it was determined that some amount would be received, although the exact amount could not be fixed. The court said:

> "The petitioner correctly states that at the date of the Act's adoption no railroad had a vested right in any amount; * * * The petitioner says that at the date of the passage of the act it was impossible to predict that any award would be made to the railway, and, assuming one would eventuate, its amount could not be estimated, * * * The Government

> insists that while adjustments or settlements of principles by the Commission might vary the amount to be awarded, the petitioner's case presented problems not differing from those confronting many business concerns which keep accounts on an accrual basis *and have to estimate for the tax year the amount to be received on transactions undoubtedly allocable to such year.* The case * * * presents the problem whether the taxpayer had in its own books and accounts data to which it could apply the calculations required by the statute and ascertain the quantum of the award within reasonable limits."

In this last case the Government squarely took the position that the "taxpayer should return the *estimated* award." In Law Opinion 1059, Cumulative Bulletin 4, pages 147, 151, the Solicitor of Internal Revenue, citing T. D. 2433, recognized that,

> "few accrued liabilities are estimated with absolute accuracy, and it is generally necessary to make adjustments from time to time in these accounts as the situation requires."

The proper method of return is not different because the figures in question are made up of a multitude of small items, even where there may be uncertainty as to what particular component items will ultimately enter into the final figure, provided that the gross result of all of the items can be foretold with reasonable accuracy.

In *Virginia-Lincoln Furniture Corp. v. Com'r of Int. Rev.*, 56 F. (2d) 1028, (C. C. A. 4), the taxpayer showed accounts receivable at the end of a year. The customers from

whom these accounts were due were permitted certain discounts. A reserve against these discounts, in an amount dictated by experience, was set up and disallowed by the Commissioner. The Circuit Court of Appeals held that the deduction was proper. In answering the very argument which will be urged here, the court said:

> "Even though there be contingencies as to any particular account, if the experience of the company is such that upon the accounts taken as a whole, it is possible to predict with substantial accuracy what the discount will be, a deduction in anticipation of same should be allowed. It is the total of the accounts which is considered in computing income, and, if the discount which will be allowed from this total can be determined with reasonable certainty, there is no reason why the same should not be deducted."

It will be said that this case differs from ours because our commission was actually received and subject to the petitioner's absolute disposition, while in the *Virginia-Lincoln Case* the gross income was not actually received. The attempted distinction falls into error in two respects. There is no showing that the commission we accounted for was in fact received—our books were on the accrual basis and showed simply what we should have received, not what we actually received. Secondly, under the accrual system actual receipts and disbursements cut no figure. "The year of the payment of the interest, and the year when the interest matured, have no importance, where accounting is on the accrual basis." (*Miller & Vidor Lumber Co. v. Com'r of Int. Rev.*, 39 F. (2d) 890—C. C. A. 5.)

The very essence of the accrual system as to income is that it should be accrued, shown, treated as received, and returned as of the time when it was earned, irrespective of when it was received. Income earned and due should be returned though not received. The reverse is true. Money received but not earned is held subject to an obligation, and must be reduced by the amount which is deferred.

In *Alpha Portland Cement Co. v. U. S.*, 67 Ct. Cls. 680, the taxpayer sold cement in sacks, under an agreement to redeem the bags by making a stipulated refund for every bag returned. To meet this it set up on its books a "return-bag liability," and in making its income tax return sought to deduct this. The Commissioner disallowed this. The court sustaining the position of the taxpayer, said:

> "It seems clear that the company's method of book-keeping was calculated clearly to reflect its income, and was within the intent of said Section 212(b). On the other hand it is clear that the Commissioner's method does not reflect but distorts the company's income. The company's method of accounting for its bags provides a necessary and proper consideration of its contractual obligation to refund the charges for the bags made at the time of shipment.
>
> "This obligation was a legal liability, the amount of which was readily ascertainable, for the company's experience, and that of others in the industry, was that 90% of the bags outstanding at the end of 1918 would be returned in the due course of its business.
>
> "In view of the above, it is apparent that to treat more than 10% of plaintiff's 'Return-bag liability' of $41,959.29 as income, would be a plain distortion of plaintiff's income for the year 1918, because 90% of

> the above amount, which sum the experience of the trade shows must be refunded, is 'properly attributable to the process' of earning income during that period."

On similar facts this case was followed in *La Salle Cement Co. v. Com'r of Int. Rev.*, 59 F. (2d) 361, 362-363 (C. C. A. 7—cert. den. 287 U. S. 624, 77 L. ed. 32, Adv. Op.).

There are other considerations indicating the propriety of the method of return used by petitioner. It is conceded in the concurring opinion of the Circuit Court of Appeals, and was conceded in the Government's brief before that court (pages 12 and 28), that the method used by petitioner would reflect income at least as accurately as that urged for respondent. The Treasury Regulations supply us with persuasive analogies. We have set out in Appendix A the Regulations dealing with long-term contracts (page v), redemption of trading stamps (page vi), and bad debts (page ix). It is true that there is now statutory authority for the last. But there was no specific statutory authority when, as a construction of the Revenue Act of 1918, these articles were first incorporated in Regulations 45. We apprehend that the method of accounting for bad debts outlined by the Treasury Department is not robbed of its persuasive force as indicating by analogy what the correct accounting method is here, because it later received congressional approval.

But there is a more persuasive analogy. Through the Revenue Act of 1918, fire insurance companies were required to return their income, as other corporations did

(*Mass. M. L. Ins. v. U. S.*, 288 U. S. 269, 77 L. ed. 435—Adv. Op., Oct. Term 1932, No. 322), except that §12 (39 Stat. 767, as amended; Fed. Stat. Ann. 1918, 329) specifically permitted deduction "in the case of fire insurance companies" of "the net addition, if any, required by law to be made within the year to reserve funds." This court has held that "unearned premium reserve" is a familiar type of insurance reserve, and a strictly technical reserve within the meaning of this statute (*Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297, decided under the Act of 1913). Our overriding commission income is merely a percentage of the premium income of the companies. Our unearned overriding commission reserve is merely a percentage of the unearned premium reserve of the companies. The companies set up a reserve for premiums which must be returned, and we set up a reserve which is a percentage of that, for our share—the return commission.

The fact that this result is arrived at under a particular statute means simply that Congress has determined on an appropriate method of accounting. Congress was not originating or creating a method of accounting—it simply approved pre-existing accounting practice. (See Journal of Accountancy, Audits of Fire Insurance Companies, by Felix Hebert, Appendix E, page xxxviii.) Even though the statute does not apply in terms the "method of accounting * * * in keeping the books" which it approves, will be just as appropriate wherever similar facts are to be dealt with. (See *Gooch v. Oregon Short Line R. R. Co.*, infra, page 57.) The figures we are dealing with are a percentage of the fire insurance company's figures. The analogy is mathematically perfect.

(c) The second method of return urged by petitioner was suggested by an Act of Congress. In 1921 Congress determined that in the case of fire insurance companies it would be more accurate to have premium income returned on a pro rata basis, returning the income actually earned within the year. Accordingly, by §246 of the Revenue Act of 1921, it was provided that companies other than mutual and life should make return on the following basis: Return as gross income

> "The combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;
>
> " * * *
>
> "The term 'underwriting income' means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;
>
> "The term 'premiums earned on insurance contracts during the taxable year' means an amount computed as follows:
>
> "From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums and premiums paid for reinsurance. To the result obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

This statute was carried into the later acts. See 26 U. S. C., §1006 (Revenue Act of 1924 and 1926, §246, 43 Stat. 290,

and 44 Stat. 48), 26 U. S. C., §2204 (Revenue Act of 1928, §204, 45 Stat. 844), 26 U. S. C., §3204 (Revenue Act of 1932, §204, 47 Stat. 225).

These statutes in terms apply only to insurance companies, not to general agencies. This is not conclusive, "for, * * *, it is obvious that a statute may indicate a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. *Johnson v. United States,* 163 Fed. 30, 32, 98 C. C. A. 508, 18 L. R. A. (N. S.) 1194." (*Gooch v. Oregon Short Line R. R. Co.,* 258 U. S. 22, 24, 66 L. ed. 443, 445. *Acc., South & Central Am. C. Co. v. Panama R. Co.,* 237 N. Y. 287, 142 N. E. 666, 667.)

Again, Congress created nothing. The Act merely sanctioned the use, for income tax purposes, of established accounting practice—a general practice of accounting by no means confined to insurance companies.

Kester Accounting—Theory and Practice (Appendix E, page xi et seq.);

Esquerre, Applied Theory of Accounts, (Appendix E, page xxvii);

Wiegand, Fire Insurance Accounting, (Appendix E, page xliv);

Montgomery, Federal Tax Handbook, (Appendix E, page xxx);

Knight, Bookkeeping (Appendix E, page xxv);

Accounting Terminology (Appendix E, page xxxvi);

Finney, Principles of Accounting, (Appendix E, page xxxvi);

Lough, Business Finance (Appendix E, page xxxvii).

The petitioner on this basis proved the actual earned income for each year in question. This was done by prorating the commission over the life of the various policies. This work was done by Mr. Logan. He testified that he was familiar with the underwriting and investment exhibits of the annual statement approved by the National Convention of Insurance Commissioners (see statute quoted above, page 56), with the method used on these reports for prorating premiums, and that he had used the same method. (R. 199.) This method is to average the policies written for a year by assuming them to be written at the middle of the year, and prorating the premium. Thus one-half of the premium (and commission) of all one year policies written within a year, will be earned that year, and the other half the next year. As to three year policies earnings are segregated on this basis one-sixth to the first year, one-third to the second year, one-third to the third year, and one-sixth to the fourth year. (This is explained in detail in the record, at pages 199-201. See, also, Wiegand, Fire Insurance Accounting, Appendix E, page xliv; Cf. Hebert at page xxxix.) The exhibits showing the results are petitioner's Exhibits 20, 21, 22, 23, 24, and 27. These show the computations on two theories—(1) on the theory that the petitioner must show all insurance written by Edward Brown & Sons and in force in 1923 and later, going back to 1918 for five year policies, and, (2) on the theory, that in order to pick up earnings in 1923 and later years petitioner need go back only to the time when he became sole proprietor of the business, which was when his brother died, August 1, 1922. The accuracy of these figures has never been questioned.

It is believed that this second method, approved by Congress, is the more accurate of the two; that it more nearly accords with the accrual method of keeping accounts, and that since petitioner's tax has been opened for redetermination this method should be used.

(d) If the method upon which the return was made is to be used, we cannot, of course, deduct for 1923 both a reserve against cancellation in later years and the return actually made in 1923. To apply the system correctly it would be necessary to set up a reserve as of December 31, 1922 and charge cancellations of business written before that date against that reserve. The figures to this end were proved and appropriate computations made. (R. 239-245; Exhibits 29 and 30.) We anticipated the argument that we would be claiming double deductions. The appropriate calculations to meet it have been made.

If the strict actuarial method is to be used, then we must account for all commissions earned, and to do this must pick up figures for business written before, but in force in, the years in question. It is submitted that in doing this we need not go back to 1918, but are required only to pick up the commission on policies written while petitioner was the sole proprietor of the business, and thereafter. The death of Herbert Brown dissolved the partnership existing between him and petitioner. (*Cal. Civ. Cod.*, §2450, as it existed in 1922, expressly provided that "a general partnership is dissolved as to all the partners * * * by the death of a partner." 47 *C. J.*, 1040.) The business which petitioner conducted after his brother's death was something new—it was not the partnership business. His title

to the assets of *that* business was a new and different title. He had no title to any of the partnership assets. He had only a right in any net which might remain on dissolution or on an accounting.

47 *C. J.*, 780;
Buckley v. Carlisle, 2 Cal. 420;
Chase v. Steel, 9 Cal. 64;
Driscoll v. Driscoll, 143 Cal. 528;
Fong Sing v. O'Dell, 50 Cal. App. 55.

On dissolution of the partnership the only power over its assets, which the petitioner had, was the power of liquidation. (47 *C. J.*, 1040; *Cal. Civ. Cod.*, 1922, §§2458-2462; *Cal. Cod. Civ. Proc.*, 1922 §1585.)

To go back only to August, 1922, will not deprive the Government of any tax. The tax on all commission shown on the old partnership books was paid to the Government under the old basis of return, when Herbert Brown and petitioner made their returns as partners and individuals for 1918-1922. This consideration is pointed out simply to prevent again income taxing upon which the Government has already collected its toll.

Criticisms of Suggested Methods of Return.

Against these considerations and authorities, it is first suggested by the court below that the taxpayer should account for income in the year in which he received it and not at some indefinite future time of his own selection. If it is meant that income received must be returned, without deduction for liabilities concurrently incurred although not yet paid, the statement, we say with deference, is in-

accurate and in conflict with the decisions of this court, where the books are kept on the accrual basis. The implication that the petitioner here is seeking to return his income "at some indefinite future time of his own selection," is unwarranted. Whether the return be made by returning income received less a reserve, or be returned on a strict pro rata and actuarial basis, as earned, the income will not be returned at some future and indefinite time, but the time and amount of return is definitely fixed by the life of the insurance policies to which the commission relates. *The time and method selected by the petitioner, far from being indefinite and of his own selection, are the exact methods which Congress prescribed for fire insurance companies.*

Next, the opinion states that the methods urged will make the collection of revenue uncertain, and make the Government gamble on the continued solvency of the taxpayer. To this there are two answers. If this is true, it is a consideration which should be urged on Congress. If there is such a risk, it is one which the Government has been willing to take, to date. The risk is expressly taken with insurance companies. It is impliedly taken in every case, for taxpayers are permitted themselves to assess the tax in the first instance. It is common knowledge that it is sometimes a matter of years before returns are audited, litigated, and the final tax fixed and paid. But the real answer is that there is no such risk. If a proper method of return shows that the Government is entitled, in a particular year, to only a given amount as tax, that in itself is a complete answer. If, in arriving at the amount of the income to be taxed, allowance is made for obligations

owed to third persons, and if the taxpayer cannot meet those obligations in the future, the loss is not that of the Government but of the obligees.

Finally, it is said that reserves to cover contingent liabilities are not allowed as deductions unless sanctioned by statute. The cases upon which we rely, as indicating that such a reserve as was sought to be set up here is properly allowable, have already been noticed. It remains only to say that an analysis of the cases cited will not support the holding of the court here.

Three of the cases cited and relied upon were cases of attempts to deduct an amount as a "reserve" against a single isolated and *disputed* claim. This reserve was attempted to be set up in advance of determination of either liability itself or the amount of any liability.

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Consolidated T. Co. v. Bowers, 19 F. (2d) 382 (D. C.);

Lane Construction Corp., 17 B. T. A. 826, 49 F. (2d) 1080 (C. C. A. 2).

The *Lucas Case* is expressly distinguished in *Virginia-Lincoln Furniture Co. v. Commissioner*, supra. The "reserve" in the *Lucas Case* had no relation to any anticipated liability. See pages 49-50 above.

Spring Canyon Coal Co. v. Commissioner, 43 F. (2d) 78 (C. C. A. 10) was an attempt to deduct a so-called "reserve" to meet possible liability on tort claims, where the facts—the accidents—upon which such claims might be predicated, had not yet occurred.

Highland Milk Condensing Co. v. Phillips, 34 F. (2d) 777 (C. C. A. 3), was an attempt to deduct repayments made to buyers of merchandise to protect them against a declining market. There was no past experience for such a deduction, either as to amount, time, or necessity. It was a single, isolated, and unusual matter.

Earle v. Commissioner, 38 F. (2d) 965 (C. C. A. 1), did not involve any question of deductions for liabilities, contingent or otherwise, but presented a question as to the proper method of return of a partner's distributive share under Rev. Act. 1921 §218 upon dissolution of the partnership by death. The general statement made that income for one year cannot be wiped out by losses of another year is correct as a general statement, of course.

William J. Ostheimer, 1 B. T. A. 18, has little to recommend it, and is believed out of harmony with the views of this court. (Compare particularly *Gambrinus Brewery Co. v. Anderson*, 282 U. S. 638, 75 L. ed. 588.) Be that as it may, the case has no analogy here. There a reserve to meet a possible liability to return leased chattels in as good condition as when they were let, was set up because the lessee was faced with the impossibility of the renewal of the lease due to national prohibition. No basis for the "reserve" was shown. One member of the Board dissented.

Thomas Cronin Co. v. Lewellyn, 9 F. (2d) 974 (D. C.) and *Uvalde Co.*, 1 B. T. A. 932, involved street paving contracts. The contractor was paid at the completion of his work. According to his contract he was required to repair any defects which might appear within a stated length

of time. He set up a fund to meet the anticipated expenses. It was held that this was not a proper deduction. The amounts were apparently based on pure guess, and it was found that it was impossible on any basis to determine the amount necessary to be deducted. In addition, it is to be noticed, that if the contract were properly performed in the first instance, there would be no defects and no expense of repair. This is pointed out in the *Thomas Cronin Co. Case*. These cases have been severely commented on by text writers. See *Montgomery, Income Tax Procedure*, 1927 Ed. 239, 241, 244, 265 and 268; *Montgomery, Federal Tax Handbook*, p. 19 et seq.; *Klein, Federal Income Tax*, 137 (quoted with approval in *Virginia-Lincoln Furniture Corp. v. Commissioner*, supra), stating that "it is unthinkable that a higher tribunal, or the Board itself, will not change the situation sooner or later."

The other two authorities cited are *Jackson Casket & Mfg. Co.*, 7 B. T. A. 1190, and *Landesman-Hirschheimer Co.*, 15 B. T. A. 604. These are discount cases—customers were permitted a discount on performance of certain conditions. A reserve was set up to meet this discount. This reserve was disallowed. But this line of cases did not stop here. It was continued, and the rule of these cases followed in the *Virginia Table Case*, another discount case. This case was appealed to the Circuit Court of Appeals for the Fourth Circuit as *Virginia-Lincoln Furniture Corp. v. Commissioner*, 56 F. (2d) 1028, to which reference has been made several times. The court reversed the Board of Tax Appeals, and expressly disapproved this line of cases in the Board. The order in the *Landesman-Hirschheimer Co. Case* was affirmed on appeal, but this was solely upon the

ground that the record was incomplete (44 F. (2d) 521—C. C. A. 6.) The Circuit Court of Appeals, in the course of its opinion said:

> "*But the income tax laws are predicated upon the assumption of a true valuation of both tangible property and choses in action.* It follows that, where a reserve is created to take care of depreciation or obsolescence, or to provide for that portion of accounts receivable which, in all probability, will never be collected, the function of such reserve is not to provide for contemplated capital expenditure, but rather to prevent an unwarranted increase in surplus, *by limiting the particular asset item to its true value.* In the case of accounts receivable, such purpose is to show the probable, true, present value of the accounts, or that sum which it is expected will be realized from such accounts. This is an income item, and the amount of discounts actually taken during the current year, is properly handled in the profit and loss statement for that year or by a deduction from current income, figuring the amount of such income as the sum of the undiscounted items, deducting the discounts and thus arriving at the actual or true income. These probable future deductions from income can in no true sense be said to be capital embarked by the stockholders in the enterprise, or earned therein, for, if the discount be taken, it will not have been earned. *The real situation could better be shown by deducting the amount of the reserve from the total of the accounts receivable, on the asset side of the statement, and thus fixing the valuation of accounts receivable at that sum which is probably collectible thereon.*"

In the concurring opinion it is first suggested that we are not entitled to deduct a reserve, and also the premiums actually returned. This is conceded, and the exhibits put into the record, by the petitioner show adjustments to prevent duplicate deduction (see page 59 above and *Virginia-Lincoln Furniture Corp. v. Commissioner,* handling a similar situation). It is also said that if the deductions sought to be taken are reasonable, it will make no difference in the long run how the returns are made—whether on the basis insisted upon by respondent, or on the basis insisted upon by petitioner. It is believed that this suggestion falls into error in two respects. In the first place, it is necessary to allocate income properly to the various years because of the tax rates. They vary from year to year, and are graduated according to amount of income. In the second place, "income taxes are levied upon the net income for an annual accounting period. Gains in one period may not be offset by losses in another" (*Earle v. Commissioner,* supra; cases at page 33 above). And if the suggestion is correct it cuts both ways—it applies equally to the Government. It indicates that the method we suggest will not unduly prejudice the Government, and correctly reflect true income.

CONCLUSION.

It is respectfully submitted, that the judgment of the Circuit Court of Appeals and the decisions of the Board of Tax Appeals should be reversed, and that petitioner's tax for the years in question should be assessed on the strict actuarial basis, or if not, then on the basis used by

him in making his return. The figures have not been discussed in detail, because this court will not consider matters which were not considered below. (*Burnet v. Commonwealth Imp. Co.*, 287 U. S. 415, 77 L. ed. 249—Oct. Term 1932, No. 95.)

The matter of accounting in such a way as to make each annual period complete within itself, and accurate, has more than theoretic interest. Enough appears to show that the matter is one of practical importance, both to petitioner and the Government. Even if we assume no change in tax rate from year to year and no net loss for any given year, this is still true. Experience shows that cancellations are a constant percentage of business written. If much business was written for 1923, and little for 1922 and 1924, it will decidedly distort income if the small cancellations of 1922 business are deducted from 1923, and the large cancellations of 1923 business are deducted from a small year, 1924. If income is not to be distorted it must be returned either as earned, or, each year must have charged to it the cancellations which are attributable to its business.

Dated at San Francisco, California, November 7, 1933.

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(APPENDIX FOLLOWS.)

APPENDIX A.

TREASURY REGULATIONS.

The regulations quoted are Regulations 62, relating to the Revenue Act of 1921; 65, relating to the Revenue Act of 1924; and 69, relating to the Revenue Act of 1926. In each instance corresponding articles of Regulations 74 and 77, relating to the Revenue Acts of 1928 and 1932 are given. Quotations are taken from Regulation 62 unless otherwise noted. In some few instances there are verbal changes, but these are not noticed unless they change the meaning.

"Art. 21. **Meaning of net income.**—The tax imposed by the statute is upon income. In the computation of the tax various classes of income must be considered: (a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. *Income can not be determined merely by reckoning cash receipts, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property, exhaustion, and accounts payable for expenses incurred.* See sections 202, 203, 206, 213, and 214 of the statute. (b) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the statute. See section 213 and articles 71-91. (c) Net income, mean-

ing gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. See sections 214 and 215 and the articles thereunder. (d) Net income less credits. See section 216 and articles 301-306. The surtax is imposed upon net income; the normal tax upon net income less credits. *Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income'. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer.* As to the net income of corporations see section 232 and article 531."

(Regs. 74 & 77, Art. 41.)

"Art. 22. **Computation of net income.**—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. *Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money.* The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income.

If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 51. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

(Regs. 74 & 77, Art. 321.)

"Art. 23. **Bases of computation.**—(1) *Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of 'paid', 'paid or accrued', and 'paid or incurred'. All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period.* See section 213 (a). For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. See article 53. On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer

prior to the realization of such appreciation through sale or conversion of the property. But see section 203.

"* * *"

(Regs. 74 & 77, Art. 322.)

"Art. 24. **Methods of accounting.**—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, *and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.* Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. See section 1300 of the statute and article 1711. Among the essentials are the following:

"(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see arts, 1581-1588);

"(2) Expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

"(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear,

depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. But see article 222."

(Regs. 74 & 77, Art. 323.)

"Art. 36. **Long-term contracts.**—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon the following bases:

"(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * *.

"(b) * * *

"Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. * * *."

(Regs. 74 & 77, Art. 334.)

"Art. 51. (Regs. 65 & 69, Art. 50.) **When included in gross income.**—Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer,

unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. See articles 21-24; as to dividends, see section 201 (e) and articles 1541-1549. A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. See articles 111 and 151. Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined."

(Regs. 74 & 77, Art. 331.)

"Art. 91. **Subtraction for redemption of trading stamps.**—Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light

of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (a) the total issue of stamps during each year, (b) the total stamps redeemed in each year, and (c) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required."

(Regs. 74 & 77, Art. 335.)

"Art. 111. (Regs. 65 & 69, Art. 112.) **When charges deductible.** — Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21-24 and 51. *The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year.* But see section 204 and articles 1601-1605. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest,

taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained. But see article 146. See section 252 of the statute and articles 1031-1038; see also section 214 (a) (6)."

(Regs. 74 & 77, Art. 342.)

"Art. 151. **Bad debts.**—Bad debts may be treated in either of two ways—(1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. * * *"

(Regs. 74 & 77, Art. 191.)

"Art. 155. **Reserve for bad debts.**—Taxpayers who have, prior to 1921, maintained reserve accounts for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad-debt items. * * * What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. * * *"

(Regs. 74 & 77, Art. 195.)

(Reg. 62.) "Art. 1533. * * * 'Paid' is to be construed in each instance in the light of the method used in computing net income, whether on an accrual or a receipts basis. See article 23."

(Regs. 65 & 69) "Art. 1523. The taxable year is the time unit for the purpose of the tax. * * * The terms 'paid or incurred' and 'paid or accrued' will be construed *according to the method of accounting upon the basis of which net income is computed by the taxpayer.* The deductions and credits provided for in this title must be taken for the taxable year in which 'paid or accrued', or 'paid or incurred', unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. * * *"

(Regs. 74 & 77, Art. 341.)

APPENDIX B.

The Treasury Department, pursuant to Section 13(d) of Part II of the Act of 1916, issued Treasury Decision 2433 as follows (Treasury Decisions, Vol. 19, p. 5):

"Corporations keeping books in accordance with standard systems of accounting or in conformity with the requirements of some Federal, State, or municipal authority having supervision over such corporations, may make their returns on the basis on which their books are kept, provided the books so kept and the returns so made reflect the true net income of the corporations for each year. (Syllabus.)

"Treasury Department,
"Office of Commissioner
"of Internal Revenue,
"Washington, D. C., January 8, 1917.

"To collectors of Internal Revenue:

"Subparagraph (d) of Section 13, of Title I of the act of September 8, 1916, provides that—

"'A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.'

"Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

"In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs

for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

"This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

"If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements.

"The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts,

capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

"W. H. OSBORN,
"Commissioner of Internal Revenue.

"Approved:

"W. G. McADOO,
"Secretary of the Treasury."

Approved, quoted and cited in:

U. S. v. Anderson, 260 U. S. 422, 70 L. ed. 347;
American National Co. v. U. S., 274 U. S. 99, 101, 71 L. ed. 946, 947;
Niles Bement Pond Co. v. U. S., 281 U. S. 357, 359, 74 L. ed. 901, 903;
Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234.

APPENDIX C.

Idaho, Compiled Statutes § 5009, Statutes of 1915, Chapter 145, §2, p. 318, R. 167:

"Foreign Companies Except Life Must Have Resident Agents. It shall be unlawful for any foreign insurance company doing business in this state to make, write, place or cause to be made, written or placed in this state any policy, * * * unless done through an agent who is a resident of this state, legally commissioned and licensed to transact insurance business herein. A resident agent shall countersign all policies so issued (except policies of life insurance) and shall receive the full commission when the premium is paid * * *."

California Political Code, § 633d:

* * * * * * *

"Agent in state to approve risks, countersign policies, etc. No insurance company or other insurer, authorized to transact business in this state, shall make, write, place or cause to be made, written or placed, any policy * * * except through, or after a risk has been approved in writing by, an agent of the company residing in this state and regularly authorized to transact such business therein, who shall countersign all such policies * * * and receive or be credited with the premium thereon when paid, and who shall also receive any commission paid or allowed on such premium * * *."

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§ 149, 160, 183-186, 197. Sections 149 and 160 provide:

"In this section the expression 'agent' means an insurance agent licensed under this Act * * * and whose compensation or profit therefor consists wholly of a commission on premiums derived from such business * * *."

"No licensed insurer shall issue any policy unless the policy is signed or countersigned by an agent, but no agent shall sign a policy in blank or in otherwise incomplete condition."

* * * * * * *

Sections 183-186 contain detailed provisions for licensing of agents.

* * * * * * *

"197. (1) No insurer, no officer, agent, or employee of an insurer, and no insurance agent licensed under this Part shall, directly or indirectly, pay or allow, or offer or agree to pay or allow, any commission or other compensation or thing of value to any person for acting or attempting or assuming to act as an insurance agent in respect of insurance on life or property in the Province, unless that person holds at the time an insurance agent's license under this Part; and every insurer or other person who violates any provision of this section, or who knowingly receives any commission, compensation, or thing of value paid or allowed in violation of this section, shall be guilty of an offence against this Act."

* * * * * * *

Nevada Revised Laws, § 1304, as amended by Statutes 1919, 392:

"It shall be unlawful for any insurance company admitted to do business in this state to write, place, or cause to be written or placed, any policy of insurance covering property located in this State except through or by a duly authorized licensed agent of such company, residing and doing business in this State; *provided,* that where the insured calls at the principal office of the company and requests a policy, the risk may be covered, and the policy procured through the duly authorized agent in the territory wherein the risk is located; *and provided further,* that a nonresident special agent, representing a company licensed by this State may work with and assist local agents in this State in writing business, but in all cases the local agent is to retain his full commission * * *."

Montana Code, § 6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29:

"Before transacting any fire, life, or other indemnity or insurance business, each and every agent, firm, or corporation acting as agent, solicitor, or representative of such corporations or associations, shall procure annually from the state auditor a certificate of authority or license as an agent, solicitor, or representative of each corporation or association represented by him or them * * * provided, that the state auditor is hereby prohibited from issuing a certificate of authority to write policies of insurance, or to solicit and obtain and transact

insurance business as defined in this act, to any person, agent, firm or corporation, unless such person, agent, firm, or corporation is a legal resident of the state of Montana at the time such certificate of authority is issued. * * *"

Wyoming, Insurance Laws, § 11, Laws 1921, Chapter 142, § 3:

"It shall be unlawful for any insurance company, other than life, admitted to do business in this state, to write, place, or cause to be written or placed, any contract or policy of insurance covering risks located in this state, except through or by a duly authorized licensed agent of such company residing and doing business in this state; * * * provided, further, that a license may be granted to a non-resident general agent or special agent authorizing such agent to work with and assist local agents in this state, in writing business, but in all cases, the local agent is to retain his full commissions."

* * * * * * *

Oregon, Insurance Laws, § 4, Olson, Oregon Laws, § 6333, Laws 1923, Chapter 115, § 1, p. 172:

"No company * * * authorized to transact insurance * * * and not incorporated under the laws of this state, * * * shall make, write, place or cause to be made, written or placed, any policy * * * except through their regularly commissioned and licensed resident agents, who

shall countersign all policies * * * and collect the premiums therefor * * *.

* * * * * * *

"Every company duly authorized and licensed to transact insurance business * * * in the State of Oregon * * * may in respect thereof appoint an agent or agents in each city, town or village in this state, and the name of every agent appointed in accordance with the provisions of this section * * * shall be filed with the insurance commissioner * * *. The insurance commissioner, if he finds the agent qualified, shall thereupon issue to each such agent a license * * *.

* * * * * * *

"It shall be unlawful for any person * * * to write, place, procure or cause to be written, placed or procured any policy * * * except through and by a legally authorized and licensed resident agent in this state * * *."

APPENDIX D.

Bulletin issued by Federal Reserve Board entitled, "Verification of Financial Statements—Revised May, 1929", published by United States Government Printing Office, Washington, 1929.

The title page of this publication is as follows:

"VERIFICATION OF
FINANCIAL STATEMENTS
(Revised)
A METHOD OF PROCEDURE
Submitted By
THE FEDERAL RESERVE BOARD
Washington
FOR THE CONSIDERATION OF
BANKERS, MERCHANTS, MANUFACTURERS
AUDITORS, AND ACCOUNTANTS

"A revision, by the American Institute of Accountants, of suggestions for the preparation of balance-sheet statements printed in the April, 1917, issue of the Federal Reserve Bulletin and reprinted in pamphlet form in 1918 for general distribution under the title 'Approved Methods for the Preparation of Balance-Sheet Statements.'"

The bulletin contains the following:

"PREFACE

"The following suggestions for the verification and preparation of balance sheets and profit-and-loss statements are a revision of suggestions which appeared in the April, 1917, issue of the Federal Reserve Bulletin and

were reprinted for general distribution in 1918 under the title Approved Methods for the Preparation of Balance-Sheet Statements.

"The first edition was issued with the intention of standardizing the forms of statements submitted to bankers for credit purposes, and it provided a program for verification of items and uniform compilation of statements.

. . . . . .

"As a first step toward standardization the Federal Trade Commission in 1917 requested the American Institute of Accountants to prepare a memorandum on procedure. A memorandum was prepared and approved by the council of the Institute. After approval by the Federal Trade Commission the memorandum was placed before the Federal Reserve Board for consideration. The Federal Reserve Board, after conferences with representatives of the Federal Trade Commission and of the American Institute of Accountants, accepted the memorandum, gave it tentative indorsement, and submitted it to bankers and banking associations throughout the country for their consideration and criticism. The memorandum was subsequently published in pamphlet form and was reprinted several times.

"The recommendations in the memorandum have been on trial more than 10 years, and various criticisms and suggestions for minor changes have been made. Some professional accountants regard the original program of procedure as more comprehensive than their conception of a so-called balance-sheet audit but not more than is

required in the preparation of statements to be submitted by persons or companies seeking credit or loans of cash. Some accountants have felt that all the instructions were not as clear as they might be. Others have said that the procedure would not bring out all the desired information. The suggested form of certifictae did not, perhaps, make it plain that the examination was not a complete audit of the accounts, and it was to that extent misleading.

"After consideration of the desirability of a revision of the bulletin the American Institute of Accountants appointed a special committee to deal with this and certain other matters. *The result of the labors of that committee is submitted in this revised edition, which represents what the Institute believes to be the best modern practice of the profession.*"

The bulletin begins the general instructions as follows:

"GENERAL INSTRUCTIONS

"The scope of the work indicated in these instructions includes a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit-and-loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check. The procedure described is designed for the auditor's use primarily in the case of industrial and mercantile concerns, but it is also applicable in the case of most other business enterprises."

Then comes specific instructions for handling particular items. The instructions make it clear that it is intended that these various items shall be handled in such a way that there shall be shown their true present value, charging against the various items, to show the true present value, such outgo as there is likely to be in the future, and which will be referable to and reducing the present value of these items.

Under Notes Receivable, where notes have been discounted, it is stated that the company has a contingent liability which should be shown. (Instr. 19.)

Under Accounts Receivable, it is stated that if trade discounts and freight allowed have been included in accounts receivable, "an appropriate reserve should be set up". (Instr. 28.)

Under Inventories, "if goods consigned to others are included, they must be carried at cost prices, less a proper allowance for loss, damage, or expenses of possible subsequent return". (Instr. 55 (h).) Price lists are to be checked to see that cost prices are below net selling prices, and "if they are not lower an adequate reserve should be set up on the balance sheet". (Instr. 55(q).)

Under Inventories, the following instruction is given:

"The selling prices for contract work in progress should be ascertained from the contracts, and, if it is apparent that there will be a loss on the completed contract, a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress." (Instr. 55 (s).)

Under Fixed Property, the following instructions appear:

"The auditor should ascertain whether or not any installments are due on account of construction work in progress which is being carried on by outside parties; if so, the liabilities for these installments should be included on the balance sheet, as they may have a direct bearing on the amount of available cash on hand." (Instr. 57(g).)

"The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are sufficient to meet the deterioration in value of fixed properties. If in his opinion the reserves shown on the balance sheet are insufficient he should refer to the fact in his certificate." (Instr. 57 (i).)

Under Deferred Charges to Operations, the following appears:

"Unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc., are grouped in the balance sheet under the heading, 'Deferred Charges.' After the clerical accuracy of the deferred charges has been verified, the auditor should satisfy himself that they are properly carried forward to account of future operations." (Instr. 60.)

Under Accounts Payable, the following appears:

"Where a modern voucher system is not in operation, the auditor must exercise particular care to satisfy himself that all liabilities are included in the accounts, for example:

"(a) Payments shown by the cashbook to have been made subsequent to the date of the balance sheet should be analyzed to ascertain whether any of them are applicable or not to the period under review." (Instr. 73.)

Under Contingent Liabilities, it is said:

"*It is not enough that a balance sheet show what must be paid—it should set forth with as much particularity as possible what may have to be paid.* It is the duty of an auditor to discover and report upon liabilities of every description, not only definitely ascertained debts but possible debts. * * *" (Instr. 78.)

Then follow special instructions for handling endorsements, guaranties, unfulfilled contracts, taxes, damages, and liabilities on bonds and mortgages. As to taxes and damages it is said:

"The possibility of unsettled Federal and other taxes for prior years should be investigated to determine whether or not there may be a liability for which provision has not been made." (Instr. 82.)

"There may be claims or suits for damages not covered by insurance, and where the auditor finds any evidence which leads him to suspect the existence of a liability of this nature he should demand full information. He can then form an opinion as to the amount which should be set up as a contingent liability or, if the outcome is uncertain, as a reserve against possible loss." (Instr. 83.)

Under Accrued Liabilities, the general instruction is as follows:

"Interest, taxes, wages, etc., which have accrued to the end of the period under review, but are not due and pay-

able until a later date, are grouped on the balance sheet under the heading, 'accrued liabilities.' These items can be accurately verified by the books and records." (Instr. 85.)

Special attention is then directed to interest payable, taxes, with appropriate "reserve for accrued taxes" (Instr. 88), salaries, expenses, etc. Under traveling expenses and commissions, the following appears:

"Ample allowance should be made for all commissions eventually payable on sales which have been charged to customers. As commissions frequently are not payable to salesmen until payment has been received from customers, accrued commissions are often omitted from the books. They must, however, be paid out of the proceeds of the sales whose full profit has already been taken into the accounts, and they should be set up as an accrued liability." (Instr. 93.)

In immediate sequence are the following instructions:

"*Legal Expenses.*—Provision should be made for any accrued liability for legal expenses not already on the books." (Instr. 94.)

"*Damages.*—If the concern is insured against liability for damages to employees or the public, a proportion of the premiums paid in advance for the unexpired time covered by the insurance will appear in 'deferred charges.' But there may be claims or suits for damages not covered by insurance, and if the auditor finds any evidence which leads him to suspect a liability of this nature he should insist upon full information. He can then form an opinion as to the amount that should be

set up as an accrued liability or, if the outcome is uncertain, as a reserve against possible loss. The auditor should consider the adequacy or inadequacy of the accrued liability for premiums on insurance carried to cover compensation for injury to employees." (Instr. 95.)

Under the instructions for getting up profit and loss statements, the following appears:

"Allowances to customers for trade discounts, outward freights, reductions in price, etc., should be deducted from gross sales in the profit-and-loss statement." (Instr. 118.)

APPENDIX E.

Esquerre, Applied Theory of Accounts, pp. 299-301, has the following to say relative to the cash basis and the accrual basis:

The Cash Basis.—It may be that the policy of a concern is to keep its books on the "cash basis;" that is to say, to consider as income earned only that which has been received in cash, and that, correspondingly, only expenses paid in cash constitute income disbursed. This policy has the great disadvantage of not being consistent. It rests upon the possibility that the right to receive income may be lost by the failure of the debtor to pay what he owes, and upon the impossibility of enforcing payment when such contingency occurs. But if the basis is correct, it should apply also to accounts receivable recorded as a result of sales on credit, since the amount charged to customers contains not only the cost of the goods sold to them, but, as well, the profit realized on the sales. It is obvious that if it is sound theory to ignore income until it is received it is also sound theory to ignore the profit on sales until the customers have paid the indebtedness which contains those profits. Yet it is doubtful whether a single instance could be found where a business concern which claims to be on a cash basis is consistent enough to apply that basis to merchandise transactions.

The Accrual Basis.—Many concerns keep their books on the "accrual basis." This method applies the accounting principle that the primary connection between the

net assets and the net income derived therefrom, is a matter of earnings and of expense incurred, and not one of income received in cash and expenses paid in cash. It takes cognizance of the fact that unless income is recorded when earned, losses due to the failure to collect that income can not appear on financial statements.

* * * * * * *

Leaving expenses and liabilities out of the question for the time being, the adoption of the accrual basis means that, at the end of every accounting period, all income which has been earned during that period must be recorded as an accrued asset which, while perhaps not collected at the time, because it is not due, may be collected at some future time. This, of course, necessitates the recording of an income which will be credited to the profit and loss of the period, whether or not the accrued asset which it represents fails of collection. Thus, if the last interest receivable on investments in bonds of other companies or in bonds and mortgages or in loans on collateral, was received December 1, and the accounting period ends December 31, there has been earned interest for one month, which is an asset of the investor, as well as it is his income for the month of December.

(The foregoing is quoted with approval in Appendix B of the brief of Honorable William D. Mitchell, Solicitor General, in *United States v. Anderson,* 269 U. S. 422, 70 L. ed. 347.)

In Montgomery, Auditing Theory and Practice (3rd Ed.) Vol. 1, pp. 495, 496, we find the following discussion:

The Accrual Method: To be correct the income account for a given period must contain all of the earnings or revenue and all the expenses or costs applicable to that period. All transactions during the current period which apply to a previous period should have been included in that period, and all transactions which belong to the succeeding period or periods must be deferred. In the former case, if proper reserves were set up for the items, no adjustment is necessary in the current period. * * *

It is hardly possible that an accurate balance sheet or income account of any business can be prepared unless the accrual basis is adopted. Concerns which close their books immediately after the end of a fiscal period almost always fail to include some items which belong to that period. *In practically all cases the omitted items are expenses, rather than earnings, so that the errors due to omission usually unduly increase the net income.* It is therefore important for an auditor to advise that books be left open long enough to ascertain the amount of liabilities which have been incurred but not discharged at the closing date.

(The foregoing is quoted with approval in Appendix B of the brief of Honorable William D. Mitchell, Solicitor General, in *United States v. Anderson*, 269 U. S. 422, 70 L. ed. 347.)

Montgomery, Federal Tax Handbook, October 1932:

(p. 7) "*The two methods of computing net income most widely used are the 'cash basis' and the 'accrual basis', both of which are officially recognized by the Treasury.* * * * One or another of the methods of accounting referred to in the preceding paragraph is suitable to the great majority of taxpayers. * * * If the method used correctly reflects net income, it should be approved, regardless of its label, and taxpayers should appeal to the Board, or the courts if necessary, before submitting to tax on net income not correctly determined."

(pp. 8 and 9) "Although it is probable that a majority of taxpayers report on the cash basis, it is seldom that true net income can be determined on this basis. For most taxpayers, not engaged in business, whose income consists mainly of salaries, bond interest, or dividends, the use of the cash basis is justified on the ground of simplicity, even if the accrual basis more accurately reflects net income. For taxpayers engaged in business, the accrual basis is preferable, and where the use of inventories is an income-producing factor, the accrual basis is required by the Treasury. (Art. 322, Reg. 74.)

"*The only known method of applying all expenses, costs, and charges to the gross income which arises from the use of the charges is to record the costs in the period in which they belong. This is known as the accrual method.*

"*Under the accrual method everything which belongs in an accounting period is thrown into that period. Con-*

versely, every transaction in one period which affects the income of an earlier or later period is thrown out.

* * * * * * *

"Both the cash and accrual methods have been held by the Board and the courts to reflect taxable income accurately. The test is: *Does* the method used comply with the law which clearly imposes a tax on all income on an annual basis? Minor items can be disregarded if the method *adopted* and *consistently* followed substantially complies with the law."

(p. 10) "It follows very logically that the only measurement which is of any value for comparative purposes is a translation of day-by-day transactions into the net income which is derived therefrom. What is called the accrual method must be used to the fullest extent, and the danger of mistakes of fact and mistakes of judgment must be faced or net income will be incapable of determination with reasonable accuracy, either for the taxpayer's use and guidance or for the government to tax."

(p. 13) "The attitude of the Treasury and the Board is becoming increasingly illogical with respect to what constitutes the accrual method of accounting. They sometimes apply the rule properly in the case of expenses and in the case of income unrealized in cash at the end of the accounting period, but where fees or other income are collected in advance they insist on taxing such income in the year in which it is collected."

(pp. 14 and 15) "What Is Meaning of 'Accrual'.—The rulings and decisions of the Treasury and Board dealing with accruals and the accrual method of account-

ing are loaded with inconsistencies. *The fault has been not so much with the formal regulations as with their administration. When items of income arise or are collected in one period, and part of the income belongs to another period, good accounting practice requires that reserves be set up so that the first period will not have the benefit of unrealized income.* To treat such items as fees and dues paid in advance as income when received by taxpayers on the accrual basis is a mistaken position. The same mistaken attitude is evident in the treatment of certain deferred expenses such as expenses for advertising in one period to stimulate sales of the following period. The trouble seems to arise from the confusion of 'accrued' with 'due and receivable' and 'due and payable'. If this interpretation were consistently applied, bond interest, insurance premiums, etc., could be deducted only when due, irrespective of the periods in which they accrue. The inconsistency is most marked in the treatment of deductible taxes. The Board in one case (*Russell Milling Co.'s Appeal*, 1 B. T. A. 194) states:

"'Decision. It is not necessary to enter into a discussion of when taxes accrued further than to say that they can not be accrued until they become due. * * *'

"Needless to say, the foregoing does not accord with the accounting conception of an accrual, nor can it, in the author's opinion, be reconciled with the decision in *U. S. v. Anderson* (269 U. S. 422). The Treasury, however, insists that there is no conflict. (C. B. VI-1, 65; G. C. M. 1240.)"

(pp. 17, 18 and 19) "So-called Reserves.—In many cases items of income are charged with obligations which

must be met before any net taxable income can arise. Under the accrual system of accounting any obligations not discharged at the end of an accounting period are provided for by setting up the equivalent of liabilities in the form of 'reserves,' 'allowances,' 'provisions,' etc. It should be of no consequence what a bookkeeper calls the liability, the only matter of importance is the determination of true net income. The liability must be definite, however, although the amount thereof need not be certain. If the liability is contingent, no deduction is allowed.

* * * * * * *

"Some of the questionable decisions have had to do with paving contracts, land sales, etc., in which the facts were undisputed that the gross income included liabilities which diminished such gross income. The estimates which are necessary to reduce the gross income to substantially correct net income are easier to compute than are estimates for depreciation, obsolescence, and bad debts." [Compare as a justification of this comment by Montgomery the facts and procedure in *Murphy Oil Co. v. Burnet*,— U. S.—77 L. ed. 168 (Adv. Op., Oct. Term, 1932, No. 80).] "But the Treasury and the Board accept and approve such difficult and often highly inaccurate estimates and disallow more accurate estimates.

"It will require a few more court cases to reconcile tax accounting and accurate accounting.

* * * * * * *

"There are many inconsistent rulings and decisions regarding the period to which expenses belong. (See page

14 et seq.) The law provides that expenses shall be deducted in the year when 'incurred'.

* * * * * * * *

"Good accounting practice requires that current gross income be reduced by allowances for contingencies which reasonably can be reduced to figures."

(pp. 21 and 22). "The Treasury in many cases, and the Board at times, have ignored the basic principle in *U. S. v. Anderson* (269 U. S. 422) which is that the early income tax laws were changed to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the *expenses incurred in* and *properly attributable to* the process of earning income during that period. There is no intimation here that allowances for expenses and losses must not be deducted. On the contrary, no language could be clearer. We are told that Congress abandoned its receipt and payment basis and adopted the accrual basis. *Unless estimates were used, there would be no accrual system. When an expense has been 'incurred,' it does not always mean that it has become a legal liability, and when the term 'properly attributable' is used, the words are to be construed according to their ordinary meaning.* If a taxpayer makes a shipment of goods and agrees to pay the freight, there can be no net taxable income until the freight liability is deducted. It certainly was 'incurred' at the moment the income arose; the two elements are inseparable. It certainly was 'properly attributable'. The *Anderson* case makes it clear that accounting principles take care of such items. *There is only one way of doing it, however, and if the Treasury*

and the Board disregard estimates of expenses and liabilities, they ignore the only method known of carrying into effect the changes in the laws which were specifically inserted to take care of accruals.''

(pp. 336 and 337) "The Supreme Court has upheld the duty of taxpayers to include undetermined income. (*Continental Tie & Lumber Co. v. U. S.*, 52 Sup. Ct. 529.) Is it not reasonable to assume that the Supreme Court will uphold the right of a taxpayer to deduct undetermined expenses? (See *Stockbridge's Appeal*, 2 B. T. A. 327 (A); *Gude Bros.' Appeal*, 2 B. T. A. 1029; *Thatcher Co.'s Appeal*, 3 B. T. A. 154.)

"The Board has in some cases been liberal in allowing such deductions. (Retailers Fire Ins. Co.'s Appeal, 3 B. T. A. 1186 (A); Bump Confectionery Co.'s Appeal, 4 B. T. A. 50.)

"Unless such deductions are allowed true net income can never be determined."

Knight, Bookkeepnig, 1930 Ed. pp. 166-167:

"One purpose of bookkeeping is to draw a distinct line between the financial activities of fiscal periods. Each period, whether it be a month, quarter, half-year, or full year, must reflect its own income and expenses and should not contain the income or expenses of another period. * * * A business may also have items of income recorded on its books which have not actually been earned. For example, the organization may have acted as an agent for the selling of real estate and may have charged its client with the commission on the transaction in advance; that

is, with commission which has been not yet earned and will not be earned until the succeeding month or other fiscal period."

Accounting Terminology
Published by American Institute of Accountants.

"Income, Deferred: This term is used in accounting to describe income which has been received but is really applicable to a future period."

Finney, Principles of Accounting, Chapter 2, page 6:

"If the operating profits for the period are to be correctly stated, the Profit and Loss account must be charged with all of the expenses applicable to the period and with no expenses applicable to prior or future periods, and it must be credited with all income applicable to the period and with no income which is really an earning of prior or future periods."

Chapter 2, page 8:

"The rule that profits must not be anticipated is only another way of stating that unrealized profits must not be considered as earned. Attention has already been called to the impropriety of confusing a mere increase in the market value of an inventory with an unearned profit, and to the fact that profits are only earned by sales. Some of the other errors which may result in an anticipation of profits, are:

* * * * * * *

(c) Failing to make provision for deferred credits.

* * *"

Lough, Business Finance, pp. 422-423, 426-427:

"Nearly all well-managed corporations charge against the profits of each year an estimated sum, or a number of distinct estimated sums, which are intended to provide for losses and expenses that will probably arise in the future but which are incident to the operations of the current period. The sums so charged are credited to reserve accounts, which are carried on the balance sheet of the company. As to the nature and use of these reserve accounts, there is much misunderstanding. They do not consist, as people seem sometimes to imagine, of funds of cash or property set aside for the purpose of meeting future expenses. It is, in fact, easily possible that a company may accumulate large reserve accounts and yet be quite unable to meet the anticipated expenses when they actually arise. The essential character of all reserves lies in the fact that they constitute a deduction from profits. The reserves exist only in the form of entries and figures in the company's books of account. It is quite possible that a firm which carries no reserves on its balance sheet may be just as conservatively managed as the one which has large reserves. But the probabilities are the other way, for the reason that proper estimates in favor of reserve accounts assist the officers and stockholders of a company in gauging the true status of the business and therefore discredit exaggerated optimism."

"There are many other kinds of reserves which should be carried if the business of a company is to be based on sound accounting and finance. The business of many companies, for example, requires them to enter into con-

tracts which involve immediate payment on the part of the purchaser of their products, combined with a liability assumed by the company to render future service. A company publishing a magazine usually collects subscription payments in advance and contracts to deliver the magazine over a twelve months' period. This being the case, it is clear that the company actually earns the subscription payment only as it proceeds through the year with the delivery of its magazine, and that it would be improper to credit the subscription payment as income of the week or month in which it is received. The modern custom among magazine publishers is to credit an account usually called 'Unearned Subscriptions' for payments sent in by subscribers, and at the close of each month to debit this account and credit another account called 'Subscription Earnings' for the proportion actually earned by sending out magazines during that month."

Journal of Accountancy, Audits of Accounts of Fire-Insurance Companies, by Felix Hebert, pp. 81, 97-98:

"*Unearned-premium Reserve.*—The unearned-premium reserve is commonly looked upon as a fund sufficient to reinsure all the outstanding risks of a company at any given time. As required to be computed and carried as a liability, this has generally been found to be the case where a company is wound up either through liquidation or receivership proceedings. The better reason for its existence, however, is found in the provisions of fire-insurance-company contracts. In most states fire-insurance companies are prohibited by statute from issuing policies of insurance in any other than the standard forms pre-

scribed. In all these forms there is a provision that the policy may be canceled at any time at the request of the assured, and in that case the company is under obligation to return to the assured a proportion of the premium originally paid, usually on a basis known as a 'short rate' and dependent upon the length of time the policy has been in force. Such contracts also provide that the company may cancel at any time, and when cancellation is effected at the instance of the company the policy holder is entitled to receive the unearned portion of his premium on what is known as the prorata basis, also dependent upon the length of time the policy has been in force. These reinsurance or unearned-premium reserves are prescribed by statute in some states, but every insurance department requires them to be carried as a liability and so uniform is this requirement that the proportion of the premiums in force to be charged as a reserve in liabilities is made a part of the statement blank.

"The calculation of reserves on outstanding premiums is not difficult, though it does involve the consideration of many items. It may be summarized in the following brief statement: Charge every company with a liability for unearned premiums on all risks written for one year or less equal to one-half of the premiums written in the policy in force. In policies for longer terms, the unearned-premium or reinsurance reserve is calculated to be one half of the premium for the current year, and the full premium for the remaining years."

Kester, Accounting—Theory and Practice, 3d Revised Edition, Vol. 1:

(p. 14) "*Accrued Income.* This is the title under which are listed the assets representing the claims against others for income earned to date but not yet due and collectible either because of the terms of the contract governing or because of trade custom or practice."

(p. 17) "*Accrued Expenses.* Accrued expenses represent usually the accumulating but unpaid claims against the business for service rendered it, as distinguished from the Accounts Payable, which usually represent purchases of an assent of one kind or another. The item arises largely because of certain trade practices and customs in accordance with which some kinds of debts are payable periodically."

(p. 30) "Similarly, with regard to the accrued expenses mentioned on page 17, whatever expenses have been incurred that properly belong to the past period, such as wages due but unpaid, are liabilities; for the cash would be smaller by the amount of such postponed or accrued items had the claims been met during the period. The close relationship of both prepaid expenses and accrued expenses to cash is thus apparent—the one as an indirect addition to the cash, the other as an indirect deduction from or claim against cash."

(p. 133) "*Handling Prepaid and Accrued Expenses and Income.* In the buying of supplies and services, quantities are purchased which are seldom completely used up during the current period. Only that portion which the current period consumes should be charged as an ex-

pense of the period. Those portions which will benefit future periods should be deferred as charges to such future periods.

"It is equally important that all supplies and services used by the current period, whether paid for or not, should be charged to the period.

"It is also important that all income earned during the current period, whether actually received or not, should be credited to the current period; *and all income received during the current period but belonging to future periods should be deferred to those periods.*"

(p. 136) "*Adjusting and Closing Deferred Income Account.* Income is sometimes received in advance of its being earned. Banks frequently take interest at the beginning of the loan period rather than at its close; landlords require tenants to pay rentals in advance; and newspapers and magazine publishing companies receive advance payments for subscriptions to papers and periodicals to be furnished in the future. The Rental Income account is a good illustration of the handling of these deferred income items. * * * The adjustment is made by an entry of $250 for unearned rent on the debit side to effect its subtraction from the $300 credit shown in the account, thus reducing it to $50, the portion belonging to the current period. This income of $50 is transferred to the credit of the Profit and Loss account. After the rental income account is ruled off, the deferred income is entered below the ruling on the credit side, forming a part of the earnings of the next period. It is,

however, to be shown among the liabilities in the balance sheet for the current period, usually under the caption of 'Deferred Income', representing the liability of the owner to furnish to his tenant the use of the premises for the full period paid for. * * *

"*Adjusting and Closing Accrued Expense Accounts.* Just as with accrued income items, there is at the close of the fiscal period no record on the books of these accruals of expenses. Accordingly, the record must be made, the account closed, and the new account for the next period must be prepared for convenient entry."

(p. 433) "*Income Under the Accrual Method.* Both accrued and deferred income will be discussed under this head. The item, accrued income, not yet recorded at the close of the fiscal period, arises because in accordance with business custom and practice it is not received till the close of the term during which it is earned. Deferred income on the other hand, arises because it is received in advance of the period of its being earned.

"*Accrued Income.* In booking accrued income, an estimate is first made of the yearly amount of each item of income which cannot be considered as earned solely in the month when the transaction takes place. Thus, income from investments accrues day by day but it may actually be received only a few times during the year. At the close of each month, therefore, one-twelfth of the total estimated yearly amount is brought on the books as a charge to Accrued Income account and a credit to an appropriate income account. This same procedure is followed at the close of each month. When the income is actually received, it is credited to the Accrued Income account

and not to the income account. The Accrued Income account is in the nature of an account receivable and will be in balance at the end of the year if all the estimated income has actually been received by that time. * * *

"*Deferred Income.*—Income, when received in advance of its being earned, is credited to the account, Deferred Income. The title "Unearned Income" is sometimes given to this account. This account reflects the liability of the current period to the future periods which will render the service entitling them to the income. It also reflects the liability of the business to render to the customers, i. e., the payers or contributors of the income, the service or commodity paid for by them in advance. The account is a true liability account and will be carried in the ledger in the liability section. At the end of each month, or other fiscal period, the portion of this income estimated as equitably belonging to the current period will be transferred from the Deferred Income account to an appropriate income account set up in the temporary proprietorship section of the ledger. * * *

"*Expense Under the Accrual Method.*—Both accrued and deferred or prepaid expenses will be considered here.

Accrued Expense.—For expenses where the period of accrual, before settlement is made, is for more than one month—as in the case with interest on bonds payable or with royalty expense paid every six months or once a year—at the end of each month an estimate is made of the

amount accrued during the current month. The following entry, in the case of royalties, is made of this amount:

Royalty Expense.....xxx
Accrued Expenses.....xxx

At the end of the contract period when payment is made, Accrued Expenses account will be charged, no entry being made at that time to Royalty Expense account. As in the case of accrued income explained above, care must be used to make sure that the expense for the entire period has been recorded in the Accrued Expense account before entry is made of the payment."

Kester, Accounting—Theory and Practice, 1921 Ed., Vol. 2:

(p. 343) "*Deferred Income.*—This income comprises the items of income received in advance of the full performance of the service required to earn it. In cases of this kind there are in possession of the business certain assets which must be used to perform the service not yet completed in order to entitle the business to the full enjoyment of income. That is, the property of the owners is liable for the service not yet rendered. Also, in order to make a correct showing of results as between the current fiscal year and the next, this unearned income must be carried forward for credit in the period in which the service is performed."

Wiegand, Fire Insurance Accounting:

At page 56 the author discusses what he calls "the most important liability of a fire insurance company" "the unearned premium reserve". He gives three reasons "for

this obligation. The first is the accounting principle which cautions against anticipating earnings; * * *. The second reason is the provision in the standard form of policy whereby the contract may be cancelled by either party. * * * The third reason for the unearned premium liability is an express provision of the insurance law dealing with the determination of liabilities."

The author then takes up, and at pages 57-66 discusses, the methods of determining this reserve. He says, "in theory it is regarded that all policies are written on the fifteenth day of the month in which they are issued, to expire on the fifteenth day of the same month one or more years later." He then shows how the fractions representing the unearned portion of any premium may be arrived at on a monthly basis (pages 57-60), and goes on:

"*Two methods of determining liability.* Of the two methods of applying the fractions previously mentioned, the first, or the annual basis, consists of totaling the number of half months in the column for each year, as is shown below, and then dividing each total by twelve to obtain an average fraction for the year. At the close of 1923 the unearned fractions on policies during the various months of that and previous years and expiring in the years indicated are computed in the manner shown in the tabulation in figure 7. (We omit this.)

"The final fractions are those printed in the supporting schedule of the convention blank *and are the same as would be obtained if all policies were considered as written on June 30 and expiring on the same date one or more years later.*

"On this basis policies issued during the year 1923 will have unearned premium fractions at December 31, 1923, as shown in the table in Figure 8.

Term of Policies-Years	Year of Expiration	Months Earned	Months Unearned	Fraction Unearned December 31, 1923
1	1924	6	6	1/2
2	1925	6	18	3/4
3	1926	6	30	5/6
4	1927	6	42	7/8
5	1928	6	54	9/10

Figure 8. Table Showing Fractions of Unearned Premiums on Annual Basis

"These fractions are applied to the total net premiums in force in each year to give the amount unearned."

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In the Supreme Court of the United States

October Term, 1933

No. 187

ARTHUR M. BROWN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 54–69) is reported in 22 B.T.A. 678. The opinion of the Circuit Court of Appeals (R. 274–281) is reported in 63 F. (2d) 66.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 6, 1933 (R. 282–283). A petition for rehearing was denied March 21, 1933 (R. 283). The petition for a writ of certiorari was

filed June 19, 1933. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a payment of $3,000 made by the petitioner to his sister in 1923, pursuant to the terms of a modified agreement originally executed in 1902, was deductible from income as a business expense or otherwise.

2. Whether the Board of Tax Appeals and the court below erred in holding that the petitioner, accounting on the accrual basis, was obliged to report the full amount of the so-called overriding commissions received in 1923, 1925, and 1926, without deduction, either as a reserve or otherwise, on account of a contingent liability to refund certain portions of such overriding commissions in later years on account of cancellation or reinsurance.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 14–15.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 56–63) are not controverted and may be summarized as follows:

From 1896 to 1904 the petitioner, an individual residing in California, together with his father, Edward Brown, and his brother Herbert H. Brown,

was engaged in business as a general insurance agency. After the death of the father in 1904 and until 1922 the business was carried on by the petitioner and his brother. The latter died in 1922 and the business was thereafter conducted by the petitioner alone until January 1, 1924, when the petitioner's son Arthur M. Brown, Jr., was admitted as a partner. This relationship continued throughout the taxable years 1925 and 1926. The business was at all times carried on under the name Edward Brown & Sons (R. 56).

On June 1, 1902, the father and sons entered into a written agreement as to their respective interests in the business and providing (R. 56, 57):

> Before any division of profits is made the said partners mutually agree to pay monthly to Jesse H. Jones, Edith H. Halton and Ethel Brown, (the three daughters of Edward Brown and Sisters of Arthur M. Brown and Herbert H. Brown), the sum of Two Hundred and Fifty Dollars ($250.00) and Further, that whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand Dollars per annum they will pay a one-sixth proportion of such excess to the said Jessie H. Jones, Edith H. Halton, and Ethel Brown.

On May 27, 1905, a written agreement was executed between the surviving members of the partnership, the executor of the estate of Edward Brown, and the three daughters of the decedent.

This agreement was apparently lost and no proof of its contents was made (R. 58).

On May 28, 1907, the two surviving daughters of Edward Brown executed a written agreement whereby they agreed to accept from the firm the sum of $250 per month beginning June 1, 1907, and ending only by mutual agreement "in full satisfaction for all amounts which may be due, or may become due, to us, or either of us, or to the survivor of us," under the agreement dated May 27, 1905 (R. 59). This instrument provided that any further amounts to which the surviving daughters might become entitled should be retained in the net profits of the firm as the property of the petitioner and his brother.

This agreement was never modified. In 1923 the petitioner made a payment of $3,000 to his sister Edith H. Halton, in accordance with the terms of the agreement and claimed the same as a deduction in his return for that year. The deduction was disallowed by the Commissioner on the ground that the payment constituted a capital expenditure (R. 60).

During the years in question the firm of Edward Brown & Sons acted as general agents in a number of western States and Federal territories for six fire insurance companies. The firm's relationship with certain of these companies was fixed by oral conversations with their officers and with other of the companies by written agreements (R. 60).

The duties performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; issued, countersigned, and cancelled policies; received and receipted for premiums; surveyed and accepted or rejected risks; represented its principals on the local Board of Fire Underwriters; rendered all reports required of its principals by local authorities; paid the necessary license fees and taxes and "generally attended to all of the affairs of its principals in the territory in which it operated" (R. 60–61).

The firm received as its compensation, in addition to a percentage of the net profits on business written in its territory, so-called "overriding commissions," which are stated percentages of the net premiums written (R. 61).

All policies written by the firm since 1917 were for periods of one, three, or five years. These policies were subject to cancellation. If the insurance company cancelled, it was obligated to refund a ratable proportion of the premium for the unexpired term of the policy; if the assured cancelled, the company was entitled to retain the customary short-period rate for the time the policy continued in force (R. 61–62).

The firm made remittances to its principals on monthly balances, crediting itself, among other things, with the overriding commissions due on the

business written during the month and charging itself, among other things, with a proportional part of any overriding commissions previously received in respect of any business which was cancelled or reinsured in another company during the month.

The books of the firm show the gross premiums written and the premiums cancelled resulting in a percentage of cancellation approximating 22 per cent, based upon five-year periods from 1919–1923 to 1922–1926 (R. 62).

The books of account were kept on the accrual basis. Overriding commissions on new business were accounted income of the year in which the business was written and refunds of overriding commissions on account of cancellations or reinsurance were accounted expense of the year of cancellation or reinsurance (R. 63).

At the close of 1923, for the first time, a liability account denominated "Return Commissions" was set up on the firm's books. This was for the purpose of recording the firm's contingent liability to refund to insurance companies a portion of the overriding commissions received during the year on account of future cancellations and the reinsurance of business written during the year. At the close of each of the years 1924 to 1926, inclusive, the credit balance in the account was adjusted to reflect the same proportion of the overriding commissions received during the year as the total fire premiums cancelled in the next five-

year period bear to the gross fire premiums written in the same period (R. 63).

The petitioner claimed as a deduction for 1923 the amount credited to the contingent liability account at the close of that year. Similar deductions were claimed in respect of partnership net income for 1925 and 1926. All three deductions were disallowed by the Commissioner. The Board of Tax Appeals approved the action of the respondent, both with respect to the disallowance of the payment to Mrs. Halton and also with respect to the disallowance of the deductions on account of anticipated refunds of overriding commissions resulting from cancellation and reinsurance. The Circuit Court of Appeals affirmed the decision of the Board.

ARGUMENT

I

THE DISTRIBUTION TO THE PETITIONER'S SISTER

The Commissioner disallowed the deduction of the payment of $3,000 made to the petitioner's sister, Mrs. Halton, in 1923, on the ground that it was a capital expenditure. The Board of Tax Appeals and the court below found it unnecessary to pass upon the precise nature of the transaction, but held that it was not shown to be a deductible business expense. In this we submit that they were clearly right.

The petitioner urges that the payment to his sister may be "subtracted" in computing taxable

income (Pet. 4). But the petitioner has at no time indicated upon what theory he claims the deduction. From the fact that he relies upon an alleged conflict with the decision in *Commissioner* v. *Olds*, 60 F. (2d) 252 (C.C.A. 6th), it may be inferred that he would have the payment regarded as a distribution in partnership. The analogy of the two cases is far from evident. In the *Olds case* the Board of Tax Appeals found as a fact (15 B.T.A. 560) that a *bona fide* partnership existed of which the recipients of the distributions were members. The Circuit Court of Appeals accepted this finding as correct and it thereby became conclusive. *Texas & N. O. R. Co.* v. *Ry. Clerks*, 281 U.S. 548, 558. Here, on the contrary, the petitioner never claimed the existence of a partnership with his sister; the Board made no finding to that effect, and the entire record squarely negatives the existence of such a relationship.

The petitioner wholly failed to carry the burden of affirmatively establishing his right to the deduction before the Board, and the court below had no alternative but to affirm the action of the Board in disallowing it.

The petitioner suggests (Br. 37) that corresponding distributions were allowed as deductions in 1925 and 1926. Upon this premise he contends that two determinations were made by the Commissioner, one at variance with the other, and the later must prevail (Br. 36–37). We have found

nothing in the record to support the assumption relating to the treatment of corresponding items in 1925 and 1926. Even if this assumption is correct there may well have been other considerations or different evidence adduced in the later years.

II

THE OVERRIDING COMMISSIONS

The principal issue relates to the proper treatment of the so-called "overriding commission," which were stated percentages of the net premiums written. The policies of insurance were written upon the basis of one-, three-, and five-year periods. In the event of cancellation or reinsurance during the life of a given policy the petitioner was obliged to return a portion of the commission which was received when it was written.

The firm consistently accounted for overriding commissions on new business as income of the year in which the business was written. A change in this method of treatment could only be justified on the ground that net income would be more clearly reflected. It is submitted there is no such justification. The petitioner suggests (Br. 31) that the method for which he contends "as a matter of fact, will just as truly reflect an income." This is not enough—particularly so inasmuch as there is an inevitable duplication of deductions during the year of change. See the concurring opinion of Judge Wilbur, R. 280–281.

The petitioner places much emphasis upon the fact that the business was operated on the accrual basis. But this is not enough to authorize the deduction of contingent liabilities. The fact remains that the petitioner received, subject to his absolute disposition, the full amount of the overriding commissions during each of the taxable years, subject only to a possibility that he would have to refund the same or a portion thereof in later years. When such a liability actually arises the taxpayer is entitled to deduct the amount actually repaid. Such a deduction was allowed the petitioner here. But we know of no authority for the deduction of such amounts by means of a reserve before the liability has in fact arisen.

Congress has provided specifically for the allowance of reserves in certain instances, notably in the case of bad debts and certain statutory reserves of insurance companies. The right to the use of such reserves in the case of bad debts is a matter confided to the discretion of the Commissioner.[1]

[1] Section 214 (a) (7) of the Revenue Acts of 1921, 1924, and 1926 provides:

> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the commissioner, a reasonable addition to a reserve for bad debts); * * * (U.S.C. and U.S.C. App., Title 26, Sec. 955.)

The very fact that it was deemed necessary to incorporate these specific provisions in the statutes indicates that in their absence there would have been no right to secure deduction on account of reserves. The petitioner does not claim to come within any statutory reserve.

Whatever doubt may have existed with respect to the deduction of reserves not sanctioned by statute would seem to have been set at rest by the decision of this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445. This Court there said (p. 452):

> The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions. The reserve set up by the Company was of that character. It cannot be said that the loss actually paid by the Company in 1923 was, as a matter of law or of undeniable fact, sustained in 1919.

The petitioner alleges conflict (Pet. 19–20) with a number of decisions of this and other courts. The cases of *United States* v. *Anderson*, 269 U.S. 422, and *American National Co.* v. *United States*, 274 U.S. 99, are distinguished in the later decision of this Court in *Lucas* v. *American Code Co., supra*. The munitions tax involved in the *Anderson case* and the loan bonuses in the *American National Co. case* were fixed and enforceable liabilities within

the taxable year. Most of the other cases relied on by the petitioner seem similarly distinguishable.

The decision in *Virginia-Lincoln Furniture Corp.* v. *Commissioner,* 56 F. (2d) 1028 (C.C.A. 4th), comes nearest to creating a conflict of any of the cases cited by the petitioner. The court there permitted the deduction of a reserve not sanctioned by statute. The decision is believed to be at variance with the principles announced by this Court in *Lucas* v. *American Code Co., supra.* In any event there are certain significant fact differences. In the present case, the "overriding commissions" were based on the gross premiums *received* during the year less premiums actually returned whether on business written during the year or written in prior years. Otherwise the determination of the year's "net premiums written" could not be made until every policy written during that year had expired, perhaps five years later. In the *Virginia-Lincoln case* the gross income consisting of the sale price of furniture was not actually *received* when the sale was consummated. It was not a case, like the present, of a taxpayer who has actually received money subject to his absolute disposition and seeks relief from taxation because of a contingent future liability to refund. This aspect of the present case distinguishes it from every case relied upon by the petitioner.

CONCLUSION

We submit that the decision of the court below is correct. There is no conflict and the petition should be denied.

Respectfully submitted.

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JULY 1933.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or

> gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

Sections 212 (b) and 213 (a) of the Revenue Acts of 1924, c. 234, 43 Stat. 253 (U.S.C., Title 26, Secs. 953, 954), and 1926, c. 27, 44 Stat. 9 (U.S.C. App., Title 26, Secs. 953, 954), repeat the language of the corresponding sections of the Revenue Act of 1921.

Treasury Regulations 62, promulgated under the Revenue Act of 1921:

> ART. 32. *Compensation for personal services.*— * * * Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, * * * are income to the recipients; * * *.
>
> ART. 36. *Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. * * *

These provisions were carried over to the corresponding numbered articles of Treasury Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively.

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In the Supreme Court of the United States

OCTOBER TERM, 1933

No. 187

ARTHUR M. BROWN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 64–69) is reported in 22 B.T.A. 678. The opinion of the Circuit Court of Appeals (R. 274–281) is reported in 63 F. (2d) 66.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 6, 1933. (R. 282–283.) A petition for rehearing was denied March 21, 1933. (R. 283.) The petition for a writ of certiorari was filed June 19, 1933, and granted October 9, 1933. (R. 287.) The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Board of Tax Appeals and the court below erred in holding that the petitioner, accounting on the accrual basis, was obliged to report the full amount of the so-called overriding commissions received in 1923, 1925, and 1926, without deduction, either as a reserve or otherwise, on account of a contingent liability to refund certain portions of such overriding commissions in later years in the event of cancellation or reinsurance.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 29–33.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 56–63) are not controverted and may be summarized as follows:

From 1896 to 1904 the petitioner, an individual residing in California, together with his father, Edward Brown, and his brother Herbert H. Brown, was engaged in business as a general insurance agency. After the death of the father in 1904 and until 1922 the business was carried on by the petitioner and his brother. The latter died in 1922, and the business was thereafter conducted by the petitioner alone until January 1, 1924, when the petitioner's son, Arthur M. Brown, Jr., was admitted as a partner. This relationship continued throughout the taxable years 1925 and 1926. The business was at all times carried on under the name Edward Brown & Sons. (R. 56.)

During the years in question the firm of Edward Brown & Sons acted as general agent in a number of western States and Federal territories for six fire insurance companies. The firm's relationship with certain of these companies was fixed by oral conversations with their officers, and with other companies, by written agreements. (R. 60.)

The duties performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; issued, countersigned, and cancelled policies; received and receipted for premiums; surveyed and accepted or rejected risks; represented its principals on the local Board of Fire Underwriters; rendered all reports required of its principals by local authorities; paid the necessary license fees and taxes, and "generally attended to all of the affairs of its principals in the territory in which it operated." (R. 60–61.)

The firm received as its compensation, in addition to a percentage of the net profits on business written in its territory, so-called "overriding commissions," which are stated percentages of the net premiums written. (R. 61.)

All policies written by the firm since 1917 were for periods of one, three, or five years. These policies were subject to cancellation. If the insurance company cancelled, it was obligated to refund a ratable proportion of the premium for the unexpired term of the policy; if the assured cancelled, the company was entitled to retain the customary short-period

rate for the time the policy continued in force. (R. 61–62.)

The firm made remittances to its principals on monthly balances, crediting itself, among other things, with the overriding commissions due on the business written during the month, and charging itself, among other things, with a proportional part of any overriding commissions previously received in respect of any business which was cancelled or reinsured in another company during the month. (R. 62.)

The books of the firm show the gross premiums written and the premiums cancelled, the percentage of cancellations approximating 22 percent, based upon five-year periods from 1919–1923 to 1922–1926. (R. 62.)

The books of account were kept on the accrual basis. Overriding commissions on new business were accounted income of the year in which the business was written, and refunds of overriding commissions on account of cancellations or reinsurance were accounted expense of the year of cancellation or reinsurance. (R. 63.)

At the close of 1923, for the first time, a liability account denominated "Return Commissions" was set up on the firm's books. This was for the purpose of recording the firm's contingent liability to refund to insurance companies a portion of the overriding commissions received during the year on account of future cancellations and the reinsurance of business written during the year. At the close of each of the

years 1924 to 1926, inclusive, the credit balance in the account was adjusted to reflect the same proportion of the overriding commissions received during the year as the total fire premiums cancelled in the preceding five-year period bore to the gross fire premiums written in the same period. (R. 63.)

The petitioner claimed as a deduction for 1923 the amount credited to the contingent liability account at the close of that year. Similar deductions were claimed in respect of partnership net income for 1925 and 1926. All three deductions were disallowed by the Commissioner. The Board of Tax Appeals approved the action of the respondent. The Circuit Court of Appeals affirmed the decision of the Board. This Court granted certiorari limited to the question of deduction for reserves. (R. 287.)

SUMMARY OF ARGUMENT

The overriding commissions were income in the year in which the policies to which they related were written, even though they might have to be refunded in part at some future time in the event of cancellation or reinsurance. Prior to 1923 return commissions were properly treated as accrued expenses when cancellation or reinsurance took place, and the Commissioner contends that they should have been so treated in subsequent years. In 1923 the firm set up a "Return Commissions" account to record its contingent liability to repay a portion of the commissions received. The petitioner now seeks to deduct sums credited to this account in each of the years involved.

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In order to be deductible, an expense must have been "paid or incurred" during the taxable year. Nothing in the statutes permits the deduction of expenses which may be incurred in the future. Congress, in sanctioning the use of the accrual method of accounting, did not expand the class of deductible expenses or authorize the deduction of expenses not yet accrued. An expense is not accrued, within the meaning of the Acts, until all the events have occurred which establish the liability, although it is not necessary that payment be presently due or the amount definitely ascertainable. The great weight of authority supports this proposition.

While conservative accounting principles may require the establishment of the reserve in question, we are concerned only with the deductions expressly authorized by Congress. In sanctioning the deduction of reserves for bad debts, Congress has clearly indicated that reserves for other contingencies may not be deducted. There is no true analogy between the reserves for return commissions and the reserve for redemption of trading stamps (Regulations 62, Art. 91) or the special provisions for return of income derived from long term contracts. (Regulations 62, Art. 36.) Moreover, the application of these regulations is restricted to the matters there specified.

The statutory requirement that a taxpayer's return clearly reflect income refers to income as defined by the Acts, and not to the theorist's concept of income. The method of accounting employed by the firm prior to 1923 accurately reflected income as defined by the

statute. It may be doubted whether the new method reflects income any more accurately. In any event, it is within the discretion of the Commissioner to require that the taxpayer adhere to an established method of returning income when that method satisfies the statutory requirements.

The petitioner suggests as an alternative that he be permitted to report as income only the portion of the commissions earned in each year, apportioning commissions over the lives of the policies. This method is required of certain types of insurance companies, but is limited to such companies and cannot be extended to other classes of taxpayers. Moreover, the record fails to show that the commissions received are properly attributable to services performed by the petitioner after the policies have been written, or if so, to what extent. Finally, since the proposed method of accounting has neither been adopted by petitioner nor required by the Commissioner, there seems to be no reason why it should be accepted now.

ARGUMENT

The full amount of the overriding commissions received by the firm has consistently been treated as income in the year when the policies were written (R. 63) and we do not understand the petitioner to contend that this practice was improper.[1] The fact that some portion of the commissions collected might

[1] As an alternative, the petitioner suggests a wholly different method of accounting, which he contends would more accurately reflect income. This method is discussed at pages 25–27, *infra*.

be refundable in later years in the event of cancellation or reinsurance did not serve to rob them of their quality as income. Refunds were made only if and when cancellation or reinsurance took place, which might be anywhere from one to five years after the commissions were received. In the meantime, the firm's right to the commissions was absolute, and it was under no restriction, contractual or otherwise, as to their disposition, use or enjoyment. Consequently, it would seem clear that these commissions constituted income in their full amount. As this Court said in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

See also *Board* v. *Commissioner*, 51 F. (2d) 73 (C.C.A. 6th), certiorari denied, 284 U.S. 658; *Ford* v. *Commissioner*, 51 F. (2d) 206 (C.C.A. 6th), certiorari denied, 284 U.S. 666; *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d), 990 (C.C.A. 7th), certiorari denied, 284 U.S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D.C.). Cf. *Burnet* v. *Sanford & Brooks Company*, 282 U.S. 359.

Prior to 1923, commissions returned on account of cancellation or reinsurance were likewise treated as expenses of the year of such cancellation or reinsurance.

In 1923, for the first time, there was set up on the books of the firm a liability account denominated "Return Commissions," the purpose of which was to record a contingent liability to refund to the companies a portion of the commissions received during the year if and when the policies written during that year were cancelled or reinsured. The petitioner now seeks to take as a deduction from gross income the sums credited to this account, in lieu of deducting the return commissions in the year of actual cancellation or reinsurance.

It is asserted, in the first place, that the Commissioner's method of treating return commissions is erroneous because he has regarded them as cash items although income is reported on the accrual basis. (Br., p. 40.) The record does not support this statement, and we believe it to be wholly incorrect. The Board of Tax Appeals found as a fact (R. 63) that "refunds of overriding commissions, on account of policy cancellations or reinsurance, have been accounted expense of the year of cancellation or reinsurance." This can only mean that refunds were treated as accrued expenses in the year of cancellation or reinsurance, irrespective of whether they were actually paid to the companies then or later. Since the firm made monthly remittances to its principals, it is probable that in most instances accrual and payment were almost simultaneous, but this does not prevent the refunds being regarded as accrual items, or indicate that the Commissioner seeks to have them treated in any other manner.

The applicable regulations (Regulations 62, Article 23, *infra*, p. 31) require that all items of gross income and deductions be treated with reasonable consistency, and it is not to be supposed that the Commissioner has so far departed from established practice as to require that income be reported on the accrual basis and expenses on the cash basis, unless the record plainly shows that to have been the fact.

The petitioner is seeking a deduction from what is admittedly gross income. Such deductions under the Revenue Acts are a matter of legislative grace, and the taxpayer assumes the burden of showing that the facts bring his case squarely within the provisions of the statute. *Reinecke* v. *Spalding*, 280 U.S. 227, 233; *Botany Worsted Mills* v. *United States*, 278 U.S. 282, 289–290; *Burnet* v. *Houston*, 283 U.S. 223, 227. The only deductions to which the petitioner is entitled are specified in Section 214 (a) of the Revenue Acts of 1921, 1924 and 1926 (*infra*, p. 30). This section makes no provision whatever for the deduction of future expenses, no matter how accurately they may be foreseen.

Section 214 (a) (1) permits the deduction of "all the ordinary and necessary expenses *paid or incurred* during the taxable year." (Italics ours.) Thus, under the plain terms of the statute, unless the expense is paid or incurred within the taxable year it is not deductible. We think that the refunds in question may properly be classified as ordinary and necessary business expenses and that, since the taxpayer is on the accrual basis of accounting, there

may be deducted amounts presently refundable by reason of cancellations occurring during the taxable year, even though payment does not take place until some later time. The reason for this is that under the agency contracts a present liability to refund accrues when a policy is cancelled. But there is nothing in Section 214 (a) which sanctions the deduction of estimated future refunds where no present liability has actually been incurred.

The real question in issue is whether a liability to refund a portion of the overriding commissions may be said to have accrued, within the meaning of the revenue laws, prior to the cancellation or reinsurance of the policies to which the commissions relate. In contending that such liability accrues as soon as each policy is written, the petitioner appears to rely chiefly on Section 200 (4) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 228, which states that—

> * * * the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212;[2] * * *

[2] Section 200 (d) of the Revenue Acts of 1924 and 1926 is the same, with the added provision that deductions shall be taken in the year in which paid or incurred "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

The Committee on Ways and Means of the House of Representatives had this comment to make on the change (H.Rep. No. 179, 68th Cong., 1st Sess., pp. 10–11):

> (2) In subdivision (d) of this section authority is granted to the Commissioner to allow or require

and on Section 212 (b) of the several Revenue Acts (*infra*, p. 29), which provides in part:

> The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if * * * the method employed does not clearly reflect income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

It is urged that because the firm now carries on its books an account recording its contingent liability to return a portion of the commissions received, and because the estimated liability has been found to approximate closely the amounts actually refunded in each year, this method of accounting may be fol-

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deductions and credits to be taken as of a year other than that in which "paid" or "accrued" when, in his opinion, it is necessary in order *to clearly reflect the* income. The Revenue Act of 1921 in sections 214 (a) (6) and 234 (a) (4) authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

This statement is repeated in S.Rep. No. 398, 68th Cong., 1st Sess., pp. 10–11.

lowed in computing income tax, as one which is "regularly employed" and which clearly reflects income. It is apparent, however, that in enacting the sections above quoted Congress did not intend that any accounting system which the taxpayer might choose to adopt should be accepted for tax purposes, or that items of expense should be deducted in any manner other than that specified in the Acts. Legislative recognition of the accrual method merely permits the taxpayer to report income when accrued rather than when actually received, and to deduct expenses when incurred instead of when actually paid.

In order to be accrued, and therefore deductible from gross income, a liability must be fixed and absolute. It is essential that all the events shall have occurred which establish the liability, even though payment may not be presently due or the amount be definitely ascertained or ascertainable. *United States* v. *Anderson*, 269 U.S. 422; *American National Co.* v. *United States*, 274 U.S. 99; *Lucas* v. *American Code Co.*, 280 U.S. 445; *Block & Kohner Mercantile Co.* v. *United States*, 37 F. (2d) 877 (C.C.A. 8th); *Vang* v. *Lewellyn*, 35 F. (2d) 283 (C.C.A. 3d); *S. Naitove & Co.* v. *Commissioner*, 32 F. (2d) 949 (App.D.C.); *Schuster & Co.* v. *Williams*, 283 Fed. 115 (C.C.A. 7th). As stated in *Block & Kohner Mercantile Co.* v. *United States*, *supra*, p. 879:

> "Under the accrual system an expense accrues when all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due."

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The petitioner apparently concedes that no liability accrued on any individual policy until it was cancelled or reinsured, but argues that since the gross amount which the firm would be required to return on policies written in any one year could be foretold with reasonable accuracy there was in fact an accrued rather than a contingent liability in that amount. This argument, we submit, confuses the idea of accrual with the ability to estimate the amount of the liability which may at some future time be incurred. While sound accounting principles may require the setting up of a reserve for a contingency of this character, accountants are not bound by the statutory restrictions applicable to taxpayers. It is difficult to see how an estimated liability composed of numerous contingent items can be other than contingent within the meaning of the revenue laws. Cf. *Ocean Accident & Guarantee Corp., Ltd.* v. *Commissioner*, 47 F. (2d) 582 (C.C.A. 2d).

We question, further, whether the amounts which the petitioner seeks to deduct constitute reserves, strictly speaking. So far as the record discloses, no sums were actually set aside or segregated to provide for the contingency. The amounts in question were apparently not withdrawn from the business, and there was no limitation on the free use and enjoyment of them.[3] There was merely a bookkeeping

[3] Even had the sums been actually withdrawn and set aside, they would not have been deductible. See *Cleveland Ry. Co.* v. *Commissioner*, 36 F. (2d) 347 (C.C.A. 6th); *Desco Corp.* v. *United States*, 55 F. (2d) 411 (D.Del.).

entry "to record the firm's contingent liability * * *." (R. 63.)

But even if we assume that the book entries constituted a reserve, such a reserve is not deductible under the statute. Designation of the account as a "reserve" account does not avoid the difficulty arising out of the fact that the petitioner is seeking to accrue an expense before the events have occurred which establish the liability. As this Court stated in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, p. 452:

> The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions.

Among the cases cited in support of this proposition is *Appeal of Uvalde Co.*, 1 B.T.A. 932, where the Board of Tax Appeals held that the taxing Acts make no provision for the deduction of future expenses, however accurately the same may be estimated. The Court also cited with apparent approval *Kaufmann Department Stores, Inc.*, v. *Commissioner*, 11 B.T.A. 949, where the Board quoted from its earlier opinion in *Appeal of William J. Ostheimer*, 1 B.T.A. 18, as follows (pp. 953–954):

> In order that an item may be accrued, however, a liability must actually be incurred in the taxable year. *Schuster & Co.* v. *Williams*, 283 Fed. 115. The statute recognized the accrual basis of making returns by providing for the deduction of expenses *incurred* but not paid. It is apparent that no liability in praesenti was incurred under the

> terms of the lease in question in the years 1918 and 1919 however well known it might have been that a liability in some amount would be incurred at some time in the future. * * *
>
> While it may have been sound business practice on the part of the taxpayer to set up a reserve out of his income to meet a *future* liability, such a reserve is not deductible in determining net income.

The Circuit Court of Appeals for the Third Circuit affirmed the decision of the Board in the *Kaufmann* case (34 F. (2d) 257), adopting the Board's opinion as its own.

The courts, in a long line of cases, have agreed with this view and have denied taxpayers deductions of the kind here sought. Similarly, the Board of Tax Appeals, in over fifty decided cases, has consistently

[4] In addition to the cases cited above, see: *Readers Pub. Corporation* v. *United States*, 40 F. (2d) 145; *Malleable Iron Range Co.* v. *United States*, 62 C.Cls. 425; *Earle* v. *Commissioner*, 38 F. (2d) 965 (C.C.A. 1st); *Lane Construction Co.* v. *Commissioner*, 49 F. (2d) 1080 (C.C.A. 2d), affirming, *per curiam*, 17 B.T.A. 826; *Kay Manufacturing Co.* v. *Commissioner*, 53 F. (2d) 1083 (C.C.A. 2d), affirming, *per curiam*, 18 B.T.A. 753; *Highland Milk Condensing Co.* v. *Phillips*, 34 F. (2d) 777 (C.C.A. 3d), certiorari denied, 280 U.S. 608; *Sells Lumber & Manufacturing Co.* v. *Commissioner*, 41 F. (2d) 363 (C.C.A. 6th); *Lichtenberger-Ferguson Co.* v. *Welch*, 54 F. (2d) 570 (C.C.A. 9th); *Spring Canyon Coal Co.* v. *Commissioner*, 43 F. (2d) 78 (C.C.A. 10th), certiorari denied, 284 U.S. 654; *Thomas Cronin Co.* v. *Lewellyn*, 9 F. (2d) 974 (W.D. Pa.); *Consolidated Tea Co.* v. *Bowers*, 19 F. (2d) 382 (S.D.N.Y.).

denied deductions of this type.[5] The first of these cases was decided October 21, 1924. Since that time Congress has enacted the 1926, 1928 and 1932 Revenue Acts, which carried forward without substantial change the provisions here involved. This would indicate legislative approval of the Board's interpretation of the statutes.

Neither *United States* v. *Anderson*, 269 U.S. 422, *supra*, nor *American National Co.* v. *United States*, 274 U.S. 99, *supra*, relied upon so strongly by the petitioner, establishes any different principle. Those cases were distinguished by this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, and the distinction there made is applicable here. There it was said (p. 452):

> The case at bar is unlike *United States* v. *Anderson*, 269 U.S. 422. There, the liability for the munitions tax at a fixed rate on the business done in 1916 had confessedly accrued in that year and was a charge on the business of that year, although the exact amount due may not have been then ascertainable and the tax was not payable until 1917. It is also unlike *American National Co.* v. *United States*,

[5] A large group of these cases may be found in 331 C.C.H. 797–802 under the title of "Reserves". And for example see: *Appeal of William J. Ostheimer*, 1 B.T.A. 18; *Appeals of Arthur H. Leonard et al.*, 4 B.T.A. 1221; *Appeal of W. S. Buck Mercantile Co.*, 6 B.T.A. 285; *Harris-Emery Co.* v. *Commissioner*, 10 B.T.A. 297; *Jahncke Shipbuilding Co.* v. *Commissioner*, 11 B.T.A. 479; *Landesman-Hirschheimer Co.* v. *Commissioner*, 15 B.T.A. 64; *Virginia Table Co.* v. *Commissioner*, 20 B.T.A. 388; *Reuben H. Donnelly Corporation* v. *Commissioner*, 22 B.T.A. 175.

> 274 U.S. 99. There, the bonus contract provided definitely for the payment of a fixed amount. It was *debitum in praesenti, solvendum in futuro.* * * *

It may be, as petitioner contends, that sound accounting practice requires that current income be reduced by reserves for contingencies which reasonably can be reduced to figures. This, however, is conservative accounting as distinguished from legal accounting. Cf. Montgomery, *Income Tax Procedure* (1927 ed.), Vol. 1, p. 266; Kester, *Accounting, Theory and Practice*, Vol. II, pp. 445–446; Finney, *Principles of Accounting*, Vol. II, Ch. 45, p. 5, *et seq.* We are not here concerned with conservative accounting practice, but with the method of ascertaining taxable income. The Acts have their own criteria of net income for tax purposes, namely, gross income less specified deductions. As was said by this Court in *Weiss* v. *Wiener*, 279 U.S. 333, 335:

> The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. They do not charge for appreciation of property or allow a loss from a fall in market value unless realized in money by a sale. *United States* v. *S. S. White Dental Co.*, 274 U.S. 398, 401. A stockholder does not pay for accumulated profits of his corporation unless he receives a dividend.

> That is the general principle upon which these laws go. It is true that they allow for obsolescence of buildings, &c., where the loss is of materials, not of money; *but there as elsewhere the loss must be actual and present, not merely contemplated as more or less sure to occur in the future.* * * * (Italics ours.)

It is significant that the only reserves for the deduction of which express provision has been made in the statutes here involved are the reserves for bad debts, the allowance of which is made discretionary with the Commissioner, and the reserves permitted in the case of certain insurance companies by Section 234 (a) (10) and (11) and Section 245 (a) (2) and (4) of the 1921 Act and corresponding provisions of later Acts.[6] We submit that in sanctioning the deduction of these specified reserves Congress has plainly indicated that reserves for other contingencies are not deductible.[7]

[6] The statutory allowances for depreciation, obsolescence and depletion (Sec. 214 (a) (8) and (10), *infra*, p. 30) are not really reserves. These allowances are not like the replacement reserves required by conservative accounting. Cf. *Weiss* v. *Wiener*, 279 U.S. 333.

[7] The petitioner argues that since insurance companies are allowed to deduct reserves for unearned premiums which may have to be refunded, he should be allowed to deduct the similar reserves set up on his books. The insurance reserve referred to in the Acts has, however, a special technical meaning in the law of insurance and is limited in its application to insurance companies. *Maryland Casualty Company* v. *United States*, 251 U.S. 342, 350; *United States* v. *Boston Insurance Company*, 269 U.S. 197; *New York Insurance Company* v. *Edwards*, 271 U.S. 109. It can have no application to the petitioner, who is not an insurance company.

Under Section 13 (d) of the Revenue Act of 1916, c. 463, 39 Stat. 756, 771, the Treasury Department promulgated T.D. 2433 (19 Treasury Decisions 5) which permitted deduction of reserves to cover liabilities accrued but not presently payable. This ruling expressly stated (pp. 6–7):

> The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

It will be observed that under this Act and regulation reserves for bad debts were not deductible. See Holmes, *Federal Income Taxes* (1917 ed.), pp. 299–301. It is a matter of common knowledge that in an established business future losses on worthless debts may, on the basis of past experience, be estimated with reasonable accuracy. Yet it was not until the Revenue Act of 1921 that Congress for the first time gave taxpayers the right to deduct reserves for bad debts. See Section 214 (a) (7) of the Revenue Act of 1921 (*infra*, p. 30). Cf. Section 214 (a) (7) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066. See also H. Rep. No. 350, 67th Cong., 1st Sess., p. 11. The reference to reserves for bad debts on page 54 of the petitioner's brief is, therefore, misleading.

Neither the 1918 Act nor the regulations promulgated thereunder permitted the deduction of anything other than "debts ascertained to be worthless and charged off within the taxable year." See Article 151, Regulations 45 (1920 ed.). We submit that since it required an amendment to the statute to enable taxpayers to deduct bad debt reserves, it requires similar legislative action to enable the petitioner to take the deduction here sought.

The petitioner also likens the reserve for return commissions to the provision in Article 91 of Regulations 62, permitting a taxpayer who issues trading stamps or premium coupons redeemable in merchandise or cash to subtract from gross income the amount estimated to be necessary to redeem such part of the total issue of stamps or coupons as will probably be presented for redemption. It seems clear, however, that this regulation deals with a present liability, since the stamps or coupons are redeemable at any time on presentation. Here there must be more than a request for the return of commissions; there must be a cancellation or reinsurance of the policies.

Reference is also made to Article 36 of Regulations 62, which permits gross income derived from long-term contracts to be reported on the basis of percentage of completion. This article creates a limited exception to the general rule. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359. The reserve which petitioner seeks to deduct is recognized neither by statute nor by regulation.

The petitioner contends that unless he is allowed the deductions claimed, true income is not reflected, and refers to the opinion of this Court in *United States* v. *Anderson*, 269 U.S. 422, *supra*, where it was said (p. 440) that recognition of the accrual basis of accounting was designed—

> * * * to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses *incurred* in and properly attributable to the process of earning income during that period; * * *. (Italics ours.)

He argues that the refunds in later years are properly attributable to the commissions received in the taxable years. But the refunds in question do not constitute expenses contributing to the earning of income. Moreover, the future refunds were not *incurred* in the taxable year and were therefore clearly not the kind of expenditures to which this Court was referring.

A somewhat similar argument was advanced by the Government in *Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115, and was rejected by this Court in the following language (p. 120):

> * * * this section [Sec. 212 (b), *infra*, p. 29] does not justify the Commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not

> previously. In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or not at all. * * *

The theoretically perfect system of accounting, on which income earned and the expenditures made to earn it appear in one return, is impossible in a system of taxation which calls for the net result of the taxpayer's transactions during a fixed accounting period. It is of the essence of our system of taxation that it should produce revenue ascertainable and payable to the Government at regular intervals. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365. The accountant's idea of perfect bookkeeping must give way to the need for periodic revenue. The requirement in Section 212 (b) that the system of accounting clearly reflect income refers to income as defined by statute and not to the theorist's concept of income.

We submit that the system consistently employed by the firm up to 1923 accurately reflected income as defined by the statute. See Regulations 62, Article 111, *infra*, p. 32. The petitioner now seeks to abandon a practice which has been established for years and which has received the Commissioner's approval. We submit that the Act makes it discretionary with the Commissioner to permit or forbid the change, assuming that the new method satisfies the statutory requirements, which we do not concede. In such a

case this Court will not weigh the relative merits of two systems of accounting, for, as it said in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, p. 449:

> * * * the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

If the petitioner has accurately computed his reserve for future refunds, it is clear that there can be no appreciable difference in a comparison of the two methods over a given period of years. Adherence to the old method will work no hardship on the petitioner, whereas a change in accordance with petitioner's present contention will distort income in the years involved. We submit that the practice now advocated by petitioner is not only unauthorized but is unnecessary.

The petitioner relies upon a number of decisions of this and lower courts. As pointed out above, the application of *United States* v. *Anderson*, 269 U.S. 422, *supra*, and *American National Co.* v. *United States*, 274 U.S. 99, *supra*, is expressly limited by the later decision of this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*. The munitions tax involved in the *Anderson* case and the loan bonuses in

the *American National Co.* case were fixed liabilities within the taxable year. Most of the other cases relied upon by petitioner are similarly distinguishable.

In *Virginia-Lincoln Furniture Corporation* v. *Commissioner*, 56 F. (2d) 1028 (C.C.A. 4th), the court permitted the deduction of a reserve, not expressly sanctioned by statute, for discounts on sales made by the taxpayer. The decision is believed to be at variance with the principle announced by this Court in *Lucas* v. *American Code Co., supra.* In any event, the obligation to allow a discount in the event payment is made within a specified time is not analogous to the liability here involved. In the *Virginia-Lincoln Furniture Corporation* case discount and payment were simultaneous, so that the discount could more properly be regarded as one of the factors determining the amount of net income attributable to the operations of the taxable year. At the time income was actually received, it was subject to reduction by the amount of the discount. Here actual receipt and return of the commissions were in no way related.

The petitioner suggests in the alternative that he be permitted to return his income on what he terms the "actuarial" basis, that is, by accruing income derived from overriding commissions over the life of each policy. Under this method, which is sanctioned by Section 246 of the Revenue Act of 1921 only in the case of insurance companies other than life or mutual companies, each policy is assumed to

have been written in the middle of the year and the premiums are apportioned accordingly. (See petitioner's brief, p. 58.)

We question whether this argument is now open to the petitioner, inasmuch as the writ of certiorari was expressly limited to "the question of the deduction on account of reserve" (R. 287); but even if the suggested method be regarded as setting up a reserve for unearned premiums and is therefore within the limitations of the writ, we submit that it is not authorized by statute. Section 246, dealing with certain types of insurance companies, can have no application here. As this Court held in *Bowers* v. *Lawyers Mortgage Co.*, 285 U.S. 182, that section relates to specified classes of taxpayers, and in order to bring itself within the provisions of the section a taxpayer must show that it is an insurance company within the meaning of the Act, which, of course, the petitioner is not.

Nor do the facts of record justify the drawing of an analogy between the petitioner's business and that of an insurance company. In the case of an insurance company the risk assumed is spread over the life of the policy, so that it is entirely proper to apportion the advance premiums accordingly. Here it has not been shown, although the petitioner states it to be a fact (Br. pp. 10–21), that the overriding commissions constituted payment for services rendered throughout the life of the policy. The Board of Tax Appeals, on the other hand, concluded that these commissions represented compensation for services

rendered in the periods covered by the monthly settlements and should be accounted income of those periods. (R. 68.) The Board further pointed out that the multifarious duties of a general agency cannot be attributed to any particular policy written. Certain of these activities relate to the operations of the business as a whole. (R. 68.) Moreover, the firm received as compensation, in addition to the overriding commissions here involved, a percentage of the net profits on business written in its territory. (R. 61.) The petitioner has failed to show what portion of the commissions represented compensation for the performance of miscellaneous duties, as distinguished from the selling and maintenance of individual policies.

Finally, it is to be observed that the suggested actuarial method has not been adopted by the firm either in keeping its books or in making its tax returns, and has not been required by the Commissioner as clearly reflecting income. This reason alone would seem sufficient to preclude the petitioner from insisting at this time that the alternative method of computing its taxable income be accepted.

We submit that the argument as to the actuarial system of accounting, as well as the contention in respect of the reserves for return commissions, might more properly be addressed to Congress than to this Court.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted.

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DECEMBER 1933.

APPENDIX

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239, provides in part:

> SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.
>
> (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.
>
> * * * * *
>
> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid * * *; * * * or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in

the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *

* * * * *

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * *

Sections 212, 213, and 214 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267–270 (U.S.C., Title 26, Secs. 953–955) and the corresponding sections of the Revenue Act of 1926, c. 27, 44 Stat. 9, 23–27 (U.S.C.

App., Title 26, Secs. 953–955) contain provisions identical with those quoted above.

Treasury Regulations 62 (promulgated under the Revenue Act of 1921) provide in part:

> ART. 22. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. * * *. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 51. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.
>
> ART. 23. *Bases of computation.*—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. The method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *.

ART. 24. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. * * *.

* * * * *

ART. 32. *Compensation for personal services.*—* * *. Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums * * * are income to the recipients; * * *.

ART. 101. *Business expenses.*— * * *. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, traveling expenses while away from home solely in the pursuit of a trade or business (see article 101 (a)), advertising and other selling expenses * * *.

ART. 111. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24 and 51. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. But see section 204 and articles 1601–1605. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a

> going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *.

Articles 22, 23, 24, 32, 101 and 112 of Regulations 65 and 69 contain provisions identical with those quoted above.

U. S. GOVERNMENT PRINTING OFFICE: 1933

SUPREME COURT OF THE UNITED STATES.

No. 187.—October Term, 1933.

Arthur M. Brown, Petitioner, *vs.* Guy T. Helvering, Commissioner of Internal Revenue.	On Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[January 15, 1934.]

Mr. Justice Brandeis delivered the opinion of the Court.

An unincorporated concern known as Edward Brown & Sons, of San Francisco, has since 1896 acted as Pacific Coast General Agent for fire insurance companies.[1] In 1923, Arthur M. Brown conducted the concern alone. In 1925 and 1926, he and his son Arthur M. Brown, Jr. conducted it as partners. The general agent receives as compensation from its principals, among other things, a so-called "overriding commission" on the net premiums derived from business written through the local agents. The question for decision is, how the income of the petitioner, Arthur M. Brown, derived from overriding commissions during the years 1923, 1925 and 1926 should be calculated for purposes of the federal income

[1]The duties required of and performed by the general agent are described by the Board of Tax Appeals as follows: The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; received and acknowledged service of proof of loss; issued, countersigned and cancelled policies; received and receipted for premiums, surveyed all risks offered and accepted or rejected the same; represented its principals on the Pacific Board of Underwriters; computed and paid commissions due local agents; ceded or reinsured certain lines of business with treaty or other companies; computed and paid return premiums on cancelled policies; secured return of premium on cancelled reinsurance; rendered all reports required of its principals by the authorities of political subdivisions in the territory in which it operated; attended to the payment of all license fees and taxes; furnished all necessary printed matter, except policy blanks, to local agents; transferred insurance by endorsement, determined whether its principals should participate in special pools; and generally attended to all the affairs of its principals in the territory in which it operated."

tax. The Commissioner of Internal Revenue held that in determining income, the gross overriding commissions on business written during the year should not be subjected to any deduction on account of cancellations expected to occur in later years. The taxpayer contends that either the gross overriding commissions should be subjected to such a deduction or that parts of the gross overriding commissions should be allocated as earnings of future years.

The term net premium as used in providing for overriding commissions, means the gross premium on the business written less the return premium and the net cost of any reinsurance. Fire insurance policies are written for periods of one, three or five years, with the right of cancellation by either party at stipulated rates of premium return. Premiums being payable in advance (subject to the 60 day grace period), a return premium is paid to the policyholder in case of cancellation; and the general agent, who receives the premium pays the return premium. The company writing a policy frequently reinsures in another company a part of its contingent liability; and the general agent, who makes the payments for reinsurance receives, in case of cancellation, a return of a proportionate part of the cost of the cancelled reinsurance. The general agent makes to each principal remittances on monthly balances, crediting itself among other things, with the overriding commissions on premiums receivable, with the return premiums paid and with the net amount paid for reinsurance; and charging itself, among other things, with a proportionate part of any overriding commissions previously credited in respect of any business which has been cancelled during the month. Thus, whenever there is a cancellation and a return or credit of a portion of the premium and of the cost of any reinsurance, the general agent returns to the company or charges itself with a corresponding portion of the overriding commission.

Prior to 1923, overriding commissions on new business were accounted income of the year in which the business was written; and refunds of overriding commission on account of cancellations were accounted expenses of the year of cancellation. The books of the general agent have at all times been kept on the accrual basis. Although no change was made in the method of accounting between the general agent and its principals, there was set up on the

books of the concern at the close of 1923, for the first time, a liability account entitled "Return Commission." In it was recorded an estimate of the liability expected to arise out of the general agent's obligations to refund to the companies a proportionate part of the overriding commission received because of cancellations which it was expected would occur in future years. The estimate was based on the experience of the preceding five years. Thus, on the books, the year's income from overriding commissions was reduced by the amount of refunds which, it was estimated, would have to be made in future years. This changed method of accounting has been followed ever since; and the difference in the method of calculating the general agent's income has been reflected in the returns made by Brown of his taxable income.

The ratio of cancellations to premiums receivable having been 22.38 per cent for the five years ending in 1923, the gross income from overriding commissions on business written in 1923, amounting to $236,693.31, was subjected on the books to a deduction of $52,971.96; and this amount was credited to the "Return Commission" account. Similarly, at the close of each of the years 1924, 1925 and 1926 the credit balance in the "Return Commission" account was adjusted so that it bore the same relation to the overriding commissions on business written during the year as the total fire insurance premiums cancelled in the preceding five-year period bore to the gross premiums on business written during those years. The ratio of cancellations for the five years ending in 1925 having been 21.55 per cent, and the total overriding commissions $244,597.88, a deduction of $3,292.98 was made, representing the net addition to the "Return Commission" account in 1925. The ratio of cancellations to premiums for the five-year period ending in 1926 having been 21.13 per cent, and the total overriding commissions $258,677.57, a deduction was made of $1,947.77 representing the net addition to the "Return Commission" account in 1926.[2]

[2]For the year 1923, the deduction of $52,971.96, the entire amount set up as a reserve, is in dispute. Similar figures were set up for the years 1924, 1925, and 1926; but actual cancellations for each of these later years were charged not against overriding commissions, but against the return commission account as set up and carried over from the preceding year. Thus the amount in dispute for each of the years 1925 and 1926 is not the entire deduction from overriding commissions as made by the general agent, but the difference between that figure and the amounts charged to the "Return

In making his federal income tax return for the year 1923, 1925 and 1926, Brown claimed as deductions the benefit of the credits so made to the "Return Commission" account. The Commissioner of Internal Revenue disallowed these deductions; and accordingly assessed to Brown for 1923 a deficiency of $17,923.03; for 1925 a deficiency of $1,520.19; and for 1926 a deficiency of $944.30.[3] The Commissioner's determinations were sustained by the Board of Tax Appeals, 22 B. T. A. 678; and its order was affirmed by the Circuit Court of Appeals. 63 F. (2d) 66. Certiorari was granted by this Court (290 U. S. —) because of alleged conflict with the decision of Circuit Court of Appeals for the Fourth Circuit in *Virginia-Lincoln Furniture Corp.* v. *Commissioner of Internal Revenue,* 56 F. (2d) 1028 and other cases.

First. The Commissioner properly disallowed the deductions on account of the credits to the "Return Commission" account. Under the Revenue Acts taxable income is computed for annual periods. If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred. What is taxable as income is provided by the Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239.[4] Sec. 212 (a) declares "That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214." Section 214 (a) declares "That in computing net income there shall be allowed as deductions: (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The only relevant deductions allowable by law are those provided for in § 214; and the burden rests upon the tax-

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Commission" account; or, in other words, the net adjustment or addition to the account. (There was no addition for 1924.)

Judge Wilbur concurred specially below taking the ground, among others, that the result of this method was a claim in 1923 for deductions both of the entire reserve and of actual cancellations during the year.

[3]The amount of the deficiency for each year was affected by an additional claim as a deduction of $3,000 which was disallowed. It is not here in question.

[4]Sections 212, 213 and 214 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267-270, and the corresponding sections of the Revenue Act of 1926, c. 27, 44 Stat. 9, 23-27, contain provisions identical with those quoted above, except that sec. 206 of those acts is also referred to as defining deductions.

payer to show that he was entitled to the deduction claimed. *Reinecke* v. *Spalding*, 280 U. S. 227, 232.

The overriding commissions were gross income of the year in which they were receivable. As to each such commission there arose the obligation—a contingent liability—to return a proportionate part in case of cancellation. But the mere fact that some portion of it might have to be refunded in some future year in the event of cancellation or reinsurance did not affect its quality as income. Compare *American National Co.* v. *United States*, 274 U. S. 91. When received, the general agent's right to it was absolute. It was under no restriction, contractual or otherwise, as to its disposition, use or enjoyment. Compare *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417, 424.[5] The refunds during the tax year of those portions of the overriding commissions which represented cancellations during the tax year had, prior to the tax return for 1923, always been claimed as deductions; and they were apparently allowed as "necessary expenses paid or incurred during the taxable year." The right to such deductions is not now questioned. Those which the taxpayer claims now are of a very different character. They are obviously not "expenses paid during the taxable year". They are bookkeeping charges representing credits to a reserve account.

These charges on account of credits to the "Return Commission" reserve account are claimed as deductions on the ground that they are expenses "incurred," "during the taxable year." It is true that where a liability has "accrued during the taxable year" it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due, *United States* v. *Anderson*, 269 U. S. 422, 440, 441; *American National Co.* v. *United States*, 274 U. S. 99; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92; and although the amount of the liability has not been definitely ascertained. *United States* v. *Anderson, supra.*[6] Compare *Continental Tie & Lumber Co.* v. *United States*, 286 U. S. 290, 296. But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the

[5]See also Vang *v.* Lewellyn, 35 F. (2d) 283.

[6]See also Uncasville Mf'g Co. *v.* Com'r Int. Rev., 55 F. (2d) 893, 895; Ocean Accident & Guarantee Corp. *v.* Com'r Int. Rev., 47 F. (2d) 582. Compare Com'r Int. Rev. *v.* Old Dominion S. S. Co., 47 F. (2d) 148.

liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent. *Weiss* v. *Wiener*, 279 U. S. 333, 335; *Lucas* v. *American Code Co.*, 280 U. S. 445, 450, 452; compare *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109, 116; *Ewing Thomas Co.* v. *McCaughn*, 43 F. (2d) 503; *Highland Milk Condensing Co.* v. *Phillips*, 34 F. (2d) 777.

The liability of Edward Brown & Sons arising from expected future cancellations was not deductible from gross income because it was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in a future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties. This is shown by the variations in the percentages in the several five-year periods of the aggregate of refunds to the aggregate of overriding commissions.[7]

Brown argues that since insurance companies are allowed to deduct reserves for unearned premiums which may have to be refunded, he should be allowed to make the deductions claimed as being similar in character. The simple answer is that the general agent is not an insurance company; and that the deductions allowed for additions to the reserves of insurance companies are technical in character and are specifically provided for in the Revenue Acts. These technical reserves are required to be made by the insurance laws of the several States. See *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 350; *United States* v. *Boston Insurance Co.*, 269 U. S. 197; *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109. The "Return Commission" reserve here in question was voluntarily established. Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts. Section 214 mentions only the reserve for bad debts (in the discretion of the Commissioner), provided for in paragraph 7; those for depreciation and depletion, provided for in paragraphs 8 and 10; and the special provision

[7]The taxpayer testified: From my experience in the insurance business, I would say that approximately the general ratio of cancellations to business written, depending on the year, runs between 20% and 25%.

concerning future expenses in connection with casual sales of real property, provided for in paragraph 11 of section 214 as amended by the Revenue Act of 1926. 26 U. S. C. § 955. Many reserves set up by prudent business men are not allowable as deductions. See *Lucas* v. *American Code Co.*, 280 U. S. 445, 452.[8]

Brown argues also that the Revenue Acts required him to make his return "in accordance with the method of accounting regularly employed in keeping the books";[9] and that in making the deductions based on the credits to "Return Commission" account, he complied with this requirement. The Commissioner's oft-quoted[10] instruction of January 8, 1917 (No. 2433, 19 Treas. Dec. 5) is relied upon:

"In cases wherein, pursuant to the consistent practice of accounting of the corporation . . . corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserve shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made."

The accrual method of accounting had been regularly employed by Edward Brown & Sons before 1923, but no "Return Commission" account had been set up. Moreover, the method employed by the taxpayer is never conclusive. If in the opinion of the Commissioner it does not clearly reflect the income, "the computation shall be made upon such basis and in such manner," as will, in his opinion, do so. *United States* v. *Anderson*, 269 U. S. 422, 439; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449; *Lucas* v. *Ox-Fibre*

[8]Compare Barde Steel Products Corp. *v.* Com'r Int. Rev., 40 F. (2d) 412, 416; Spring Canyon Coal Co. *v.* Com'r Int. Rev., 43 F. (2d) 78.

[9]Section 212 (b) The net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if . . . the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commission does clearly reflect the income.

[10]United States *v.* Anderson, 269 U. S. 422; American National Co. *v.* United States, 274 U. S. 99, 101; Niles Bement Pond Co. *v.* United States, 281 U. S. 357, 359; Aluminum Castings Co. *v.* Routzahn, 282 U. S. 92, 98.

Brush Co., 281 U. S. 115, 120; compare *Williamsport Wire Rope Co.* v. *United States*, 277 U. S. 551; *Lucas* v. *Structural Steel Co.*, 281 U. S. 264.[11] In assessing the deficiencies, the Commissioner required in effect that the taxpayer continue to follow the method of accounting which had been in use prior to the change made in 1923. To so require was within his administrative discretion; compare *Bent* v. *Com'r Int. Rev.*, 56 F. (2d) 99.

Second. The Board of Tax Appeals did not err in refusing to allocate to future years part of the overriding commissions on business written during the taxable year. Brown urges that the overriding commission is compensation for services rendered throughout the life of the policy; that the compensation to be rendered in later years cannot be considered as earned until the required services have been performed; and that the Revenue Acts contemplate that where books are kept on the accrual basis, the income shall be accounted for as it is earned. He suggests, therefore, as an alternative method of ascertaining the income, that the commissions on each year's writing be prorated over the life of the policies.

Under this alternative proposal, the practice of making deductions prevailing prior to 1923 would remain unchanged; but the method of ascertaining the gross income of the taxable year would be subjected to a far-reaching change. The proposal is that all policies be deemed to have been written on July 1; that of the overriding commission on one-year policies, one-half should be returned as income of the year in which the policy was written, the other half as income of the next year; that of the commissions on three-year policies, one-sixth should be returned as income of the year in which the policy was written, one-third as the income of each of the next two years and one-sixth as income of the fourth year; and that the commission on five-year policies, one-tenth should be returned as income of the first year, one-fifth as income of each of the next four years, and one-tenth as income of the sixth year.

This proposed alternative method of computing the income from overriding commissions was not employed by Edward Brown & Sons either before or after 1923. Moreover, the Board concluded that there "is no proof that the overriding commissions contain

[11] See also Industrial Lumber Co. *v.* Com'r Int. Rev., 58 F. (2d) 123; Jennings *v.* Com'r Int. Rev., 59 F. (2d) 32.

any element of compensation for services to be rendered in future years." The whole of the overriding commissions has at all times been treated as income of the year in which the policy was written. The Commissioner was of opinion that the method of accounting consistently applied prior to 1923 accurately reflected the income. He was vested with a wide discretion in deciding whether to permit or to forbid a change. Compare *Bent* v. *Com'r Int. Rev.*, 56 F. (2d) 99. It is not the province of the court to weigh and determine the relative merits of systems of accounting. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449.

The deductions here claimed, not being authorized specifically either by the Revenue Acts, or by any regulation applying them, were properly disallowed. So far as the decision in *Virginia-Lincoln Furniture Corporation* v. *Commissioner of Internal Revenue*, 56 F. (2d) 1028 may be inconsistent with this opinion, it is disapproved.

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.